



**Wolkite University**

*We Strive for Wisdom!*

COLLEGE OF BUSINESS AND ECONOMICS

SCHOOL OF POST GRADUATE

DEPARTMENT OF ACCOUNTING AND FINANCE

ASSESSMENT OF TAX AUDIT PRACTICE AND ITS EFFECTIVENESS IN  
ENHANCING TAX REVENUE THE CASE OF LARGE TAX PAYERS  
BRANCH OFFICE OF ETHIOPIAN REVENUE AND CUSTOMS AUTHORITY

A THESIS SUBMITTED TO THE DEPARTMENT OF ACCOUNTING AND  
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## Abstract

*The purpose of this study is to assess the tax audit practice and its effectiveness in enhancing tax revenue of large tax payers' office. The study examines tax audit practice and its effectiveness with dimensions of experience and capable audit staff, tax payer's record keeping, tax payer's office information system, audit case selection and examination method, the type of audit used and frequency of tax audit influence audit effectiveness in LTO. In light of this objective the study adopted mixed research method of research approaches. Specifically, the study used survey of questionnaire analysis offices' on tax auditors and team leader, and interview analysis on team leaders and process owners. Then tax auditors and team leaders were selected based on Census method, because, the target population studied is small. In large tax payer's office there were 80 tax auditors supervised and lead by 10 team leaders managed by two process owners. Then the researcher distributed those questionnaires to the 90 tax auditors and team leaders, only 80 of them were returned. Consequently, Data was then analyzed on quantitative basis using inferential statistics (Anova and linear regression analysis) and descriptive statistics (frequency, percent, mean and standard deviation). Qualitatively interview was presented to process owners. The results of the study enable us to conclude that tax audit type, experience and capability of audit staff and audit case selection and examination method as a linear combination significantly influence tax audit effectiveness in the organization studied. However, tax payers record keeping, tax payers information system and frequency of tax audit were not significantly to undermine tax audit effectiveness. In the end, the study forwards the possible measures to be taken by the Ethiopian Revenue and Customs Authority to mitigate problems in tax audit operation. The authority should conduct further study to alleviate the problems which are related to tax audit.*

**Key words:** *Tax audit practice, Tax revenue, Large tax payers*

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## List of Acronyms

ERCA	Ethiopian revenue and customs authority
GDP	Gross domestic product
IA	Internal audit
IIA	Institute of internal audit
LTO	Large Taxpayers Office
MOFED	Ministry of finance and economic developments
OECD	Organization for economic co-operation and development
SPSS	Statistical packages for social science
VAT	Value added taxes



# CHAPTER ONE

## INTRODUCTION

### 1.1 Background of the Study

Taxation may not sound exciting, but it is central to the development of nations. Currently, taxation has become part and parcel of all economic activities although it fails to meet its intended objectives in numerous developing countries. Developing countries are in difficulty to collect taxes efficiently, because of many serious problems they face as to tax design and administration. They are also in trouble to provide basic social services from taxation (Damme et al. 2008). To reap the proceeds from taxation, developing countries should give great attention to the policy and administration of taxation. Good tax system, apart from generating revenue, minimizes distortion of resource allocation and simplifies its administration (World Trade Organization 2003).

Tax administration is a complex and dynamic responsibility. On a regular basis, leaders are faced with new issues, conflicting priorities, taxpayer compliance and emerging commitments (Thomson 2008). Governments of developing countries are eager to create modern tax systems although saddled with weak tax administrations, and sometimes have experimented with tax administration mechanisms that inflict higher compliance costs on the private sector (Berhan & Jenkins, 2005).

Any tax in a tax system is vulnerable for evasion and fraud, which has become the concern of many countries. Tax fraud is an intentional reduction of the tax liability stemming from real transactions. It is a deliberate misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability (Baurer, 2005). It typically includes underreporting profits and turnover, overstating deductions, underreporting employee wages, failure to register or file tax declarations, hiding of taxable receipts coming from the production and distribution of real products and services, overvaluing of VAT spent on inputs and abuse of tax return through fictitious transactions and trades.

Thus, tax audit is needed to increase tax revenue and taxpayer compliance. Tax audit is a detailed exploration into the activities of a taxpayer to determine whether he/she has been correctly declaring the tax liabilities (OECD 2006a). The inspection of the taxpayers' activities indirectly drives voluntary tax compliance, and directly generates additional tax revenue collections. As a result, both (compliance by the taxpayers and the additional tax revenue collected) help tax agencies to reduce the tax gap between the amount due and collected (Barreca & Ramachandran 2004).

A tax audit in ERCA's context is defined as: an activity or a set of activities performed by Tax auditors to determine at taxpayer's correct tax liabilities for a particular accounting or tax period, by examine of a taxpayer's organization procedures and financial records in order to assess compliance to tax laws and verifying the true, fair, reliable, and accuracy of tax returns, and financial statements. (ERCA, 2010)

In Conducting an audit, various types of information will be reviewed namely, tax returns, financial statements, accounting records, customs declaration and other source documents. Generally, an audit will examine different issues identified as most significant in achieving an accurate assessment of a taxpayer's tax liability.

Some of the typical issues will include any indications of unreported income, or potentially over claimed deductions, over /under valuation, smuggling and illegal activities.

Tax audits usually focus on areas where there is a high risk with regard to the amount of tax paid and/or payable. Depending on the specific factors relating to a taxpayer, the scope of tax auditing will often vary. However, it is important to remember that the primary objective of an audit is to determine the correct amount of tax that ought to be paid. The above stated objective is very important to tax payers as well as to tax authorities and it helps ensure that taxpayers have confidence in the fairness of the audit process such that an audit could result in either an increase or a decrease of a taxpayer's tax liability (ERCA, 2010).

A tax audit is an examination of whether a taxpayer has correctly reported its tax liability and fulfilled other obligations. It is often more detailed and extensive than other types of examination such as general desk checks, compliance visits or document matching programs (OECD 2006a).

The role of an audit program in a modern tax administration must extend beyond merely verifying a taxpayers' reported obligations and detection of discrepancies between a taxpayers' declaration and supporting documentation (Biber, 2010).

Tax audit may increase tax revenue in two ways: directly through assessment of additional taxes, and indirectly by improving taxpayer compliance with the tax laws and regulations (Barreca & Ramachandran, 2004).

## **1.2 Background of the Organization**

According to 'the domestic tax audit manual of May, 2014 head quarter of Ethiopian revenue and customs authority (ERCA) segmented its tax payers into large tax payer's office (LTO), medium tax payer's office (MTO), small tax payer's office (STO).the main purpose for the establishment of LTO is to control and provide services to those tax payers who collectively account for between 60-75 % of the governments overall tax revenue each year. Inclusion in the LTO program is determined by:-

## **1.3 Statement of the Problem**

Under inadequate tax administration including insufficient and ineffective audit program, the potential amount of tax revenue in developing and transitional countries has not been collected in an efficient and equitable manner (Edmiston & Bird, 2004). It is unmoving under a number of challenges regarding to its operation and administration that are not yet resolved. Further, weak tax administration may make the tax system unfair in that honest tax payers would bear heavier and disproportional burden. It, in turn, may have impact on the efficiency of tax operation, and also may encourage businesses to work in the illegal economy.

However, the tax base of developing countries adversely affected by administration problems including poorly conceived tax policies and lack of certainty regarding future policy changes. In addition, tax administrations can also create problems for the tax payers as they impose onerous reporting and record keeping requirements, perform excessive inspections and audits, fail to deal with their corrupt employees, and failure to provide transparency in the operations of tax administration (Baurer 2005).

In Ethiopia, taxation has been used for the purpose of raising as much revenue as possible to meet the ever-expanding public expenditure needs of the government. It is also a mechanism for reduction of inequalities in income distribution, promotion of capital investment and trade, encouraging and/or discouraging certain industries depending on how suitable for country's economic development program.

However, it is not often the case to collect the potential tax revenue in the country due to lack of awareness of taxpayers as well as paucity of tax agencies' cooperation with the business community. Tax systems are usually elaborated without proper discussion with the business community. In addition, the business owners do not have easy access to and clarification on information of the tax laws. The tax agencies do not also provide advising services. As a result, taxpayers misinterpret tax rules and regulations. Moreover, they lack awareness regarding the tax type to be imposed on their doings, purpose and operation of desk audit, goods and services exempted from tax, negative upshot of contraband trade, and reporting and filing requirements of the tax law (Getaneh 2011).

Furthermore, total tax revenue performance has been relatively poor that accounts an average of 10.9 percent of GDP during 1990-94 and 12.9 percent of GDP during 2000-06 (McKinley & Kyrili 2009). Ethiopia mobilizes not more than 14 percent of GDP in tax revenues till 2011. This may be as a result of evasion or fraud by the taxpayers which includes; underreporting profits and turnover, underreporting employee wages, failure to register or file tax declarations, dearth of willingness to operate in accordance with tax laws, non-issuance of VAT invoices for buyers, and barter arrangements hidden from tax authorities(MOFED &ERCA 2007).

To mitigate such and so fraud problems, therefore, a successful audit program should be implemented which is capable to investigate, detect and prevent loss of tax revenue. To the greatest possible extent, tax systems should be supported by clear and straightforward laws and procedures that facilitate revenue collection, develop taxpayers' awareness, and minimize taxpayers' effort and compliance costs. The administration should be provided with appropriate enforcement tools, including conduct of effective audit.

Previous studies discussed the issue of tax audit practice in Ethiopia (the case of federal government), and investigated key problems in tax audit operation (Getaneh 2011), factors

affecting tax audit effectiveness the case of large tax payers office of Ethiopian revenue and customs authority (Mahlet 2016). However, in this study the researcher tried to investigate the variables which were not touched by the previous studies. Here the researcher investigated tax audit and its effectiveness the case of large tax payers□ branch office of Ethiopian revenue and customs authority.

## **1.4 Objectives and Hypotheses**

### **1.4.1 General Objective**

The objective of this study is to investigate tax audit practice and its effectiveness in enhancing tax revenue by the case of Ethiopian revenue and custom authority of large tax payers□ branch office.

### **1.4.2 Specific Objectives**

Specifically, the study assumes the following objectives:

- i. To assess the effect of experience and capability of audit staff on tax audit effectiveness towards increasing tax revenue.
- ii. To investigate the role of taxpayers□ record keeping on the tax audit effectiveness in enhancing tax revenue.
- iii. To investigate the effect of large taxpayers□ office effective information system on the tax audit.
- iv. To identify the role that the type of audit used has on the effectiveness in enhancing tax revenue.
- v. To examine the effect of audit case selection and examination method on the tax audit effectiveness in increasing revenue.
- vi. To investigate the effect of frequency of tax audit on the effectiveness of tax audit program in enhancing tax revenue.

### **1.4.3 Research Hypotheses**

In order to achieve the above broad objective the researcher formulates the following six testable hypotheses:

*H1: Experience and capability of audit staff is positively related with tax audit effectiveness.*

*H2: Taxpayers' bookkeeping is positively related with tax audit effectiveness.*

*H3: Information system in large tax payer's office is positively related with tax audit effectiveness.*

*H4: Audit type used is positively related with tax audit effectiveness.*

*H5: Audit case selection method and audit examination is positively related with tax audit effectiveness.*

*H6: Audit rate used is positively related with tax audit effectiveness.*

## **1.5 Significance of the Study**

The primary use of this research is to the ERCA. The authority might be able to see its level and performance of tax audit activities, and learn some lessons and build some corrective measures for the weaknesses based on recommendations to be forwarded. Further, the study has paramount use for different stakeholders who are interested for such as government agencies and business associations. Finally, the study might have valuable importance for future researchers who need to conduct a study in this and related fields.

## **1.6 Scope of the Study**

The study focused on the audit part of tax administration of Ethiopia in the case of federal government large tax payers' branch office excluding regional governments due to time and resource constraints. The study assessed tax audit practice and its effectiveness, and focus on the role of taxpayers' system of recordkeeping, the effect of experience and capability of audit staff, effect of taxpayers' office information system, the role of audit type used, the effect of audit

case selection and examination method, the effect of frequency of tax audit on effectiveness of audit program in terms of improving voluntary compliance and tax revenue performance.

## **1.7. Organization of the Study**

The research is organized as follows. Chapter one is deals with introduction, which includes: Background of the study, statement of the problem, objective and hypotheses, significance of the study, and scope of the study; chapter two deals with the review of the related literature; chapter three contains the research design and methodology; which describes about the research approach, research methods, target population, sampling techniques and sources of data, data analysis, and model specification. Chapter four contains analysis and interpretation of the result. Finally, chapter five includes conclusion and recommendations.

# **CHAPTER TWO**

## **LITERATURE REVIEW**

### **INTRODUCTION**

This section presents review of existing theoretical and empirical literature on tax audit. At the end of the review, an attempt is made to summarize the major drawbacks of the existing empirical studies and to identify the knowledge gap to be filled in by further investigation. The chapter is organized in to 4 section .the first section presents the theoretical framework for audit, the second section presents empirical evidences ,the third section shows gaps in literature, the fourth section shows conceptual framework .

#### **2.1. Theoretical Literature**

An audit is the independent examination of financial statements of related financial information of an entity, whether profit oriented or not, and irrespective of its size, or legal form, when such an examination is conducted with a view to expressing an opinion thereon. (IFAC, 1993)

The American Accounting Association (AAA) has provided a broader definition of audit which refers to a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users. (AAA, 1973)

A tax audit is an examination of whether a taxpayer has correctly reported its tax liability and fulfilled other obligations. It is often more detailed and extensive than other types of examination such as general desk checks, compliance visits or document matching programs (OECD 2006a). The role of an audit program in a modern tax administration must extend beyond merely verifying a taxpayer's reported obligations and detection of discrepancies between a taxpayer's declaration and supporting documentation (Biber 2010).

Most taxpayers' report their tax liabilities more accurately if they believe that the tax administration has the capacity to detect any unreported liabilities and that heavy penalty may be

applied when they are detected (Biber 2010). Thus, tax audit results in increased tax revenue in two ways: (1) directly through assessment of additional taxes; and (2) indirectly by discouraging underreporting of liabilities by all taxpayers. Further, the purpose of tax audit is to check the evasion of tax and ensure compliance in accordance with the laws and regulations (Barreca & Ramachandran 2004).

A tax audit is one of the most sensitive contacts between the taxpayer and a revenue body. The presence of an auditor in a taxpayer's private dwelling or business premises, coupled with the exploration of private and business issues and the gathering of information from taxpayers' books and records, or just the disruption of day-to-day workflow, represents a burden on the taxpayer and may be seen by some as an unwarranted intrusion into their affairs. Notwithstanding this, tax audits remain the only effective method for ascertaining additional facts or verifying provided information.

The tax audit function plays a critical role in the administration of tax laws in all countries. In addition to their primary role of detecting and deterring noncompliance, tax auditors are often required to interpret complex laws, carry out intensive examinations of taxpayers' books and records, while through their numerous interactions with taxpayers operating very much as the "public face" of a revenue body. These factors, as well as the absolute size of the audit function in most revenues bodies, provide a strong case for all revenue bodies paying close attention to the overall management of the tax audit function. Historically, the audit function conducted by public accountants has been associated with this activity of attesting to financial statements.

Tax audit (expected to be performed by public accountants) can be thought of as an extension of this "attest function". For tax purpose, one assessee is liable to file a return to the concerned assessing officer with supporting documents sometimes required by tax law for simultaneous submission with the return. The assessee is sometimes called for by the assessing officer under the tax law for producing the same. In this context, the question of tax audit may arise. And "tax audit" means to audit an assessee's accounting and other documentary evidences to prepare the correct tax return as well as to prepare the statements showing the detailed computational working for different heads of income or items in tax return and other required evidential statements regarding allowances and disallowance for deductions and all these are to be followed

by an audit report giving the auditor's opinion about the degree of correspondence between the information content in the tax return and the regulatory provisions of the existing tax laws (AAA, 1973).

Thus, tax audit comprises the following:

- Accounts and other evidences are required to comply with the “tax basis of accounting”, i.e. as per requirement of tax laws;
- Preparation of tax return, statement of computational working for items in the return and statements containing particulars of allowances and disallowance for deduction;
- Giving audit report portraying the attest function whether the tax return and statements have been fairly prepared as per the regulatory requirement of tax laws. (WWW.Jestor)

### **2.1.1 Theories of Auditing**

Auditing theory helps explain why society needs auditing: the role and purpose of audit services in communication between a company and its environment. The agency theory is the most prominent of the existing theories.

#### **1) Agency theory**

Adams (1994) used agency theory to explain that it is in the interest of management to maintain a strong internal audit department. Implementation of audit recommendations is highly relevant to audit effectiveness (Van Gansberghe, 2005) and the management of an organization is viewed as the customer receiving internal audit services. As a result, management's commitment to use audit recommendations and its support in strengthening internal audit is vital to audit effectiveness (Sawyer, 1995).

Using agency theory is the role that internal audit plays in an economy and points out that internal audit has an advantage over external audit in obtaining information quickly and finding problems at an earlier stage (Xiangdong 1997); and applying the theory of transaction cost economics, demonstrated how internal audit recommendations are important to the management

of government organizations (Sprakman 1997). Audit findings and recommendations would not serve much purpose unless management is committed to implement them.

“Auditors are engaged as agents under contract but they are expected to be independent of the agents who manage the operations of the business. The primary purpose of audited accounts in this context is one of accountability and audits help to reinforce trust and promote stability” (Audit quality, 2005)

## **2) Positive Accounting Theory (PAT)**

Watts and Zimmerman seek to develop a positive theory of the determination of accounting standards. “Such a theory will help us to understand better the source of the pressures driving the accounting standard-setting process, the effects of various accounting standards on different groups of individuals and the allocation of resources, and why various groups are willing to expend resources trying to affect the standard-setting process (Watts & Zimmerman, 1978, 112).

## **3) Institutional theory**

The concept of institutionalization is related to organizations actions over time. Such actions are said to be legitimated within an organization and environment. Institutional theory suggests that internal operating processes loosely coupled with the observable structures accomplish the real work of an organization.

As a result, organizations with the appropriate structures in place will avoid deep investigations of their function by external auditors (Meyer & Rowan 1977). Organizations are subject to rules and regulations to which they must conform in order to ensure their legitimacy and thus have access to resources and ensure their survival (DiMaggio & Powell 1983). However, these rules and regulations don't necessarily guarantee that organizations will continue to operate efficiently (Meyer & Rowan 1977; Scott 2008). Institutional elements comprise the institutions and over time the institutional elements are given priority. The key point is to identify what institutional elements reinforce or undercut other elements (Scott 2008). Functional pressure, political pressure and social sources are three possible factors that cause pressure on institutional common practices (Oliver 1991).

#### **4) Stewardship theory**

Stewardship theory outlines a co-operative and optimistic view of relationships within the corporation by assuming that managers are good stewards and do not misappropriate corporate resources; their behavior is also conditioned by non-financial motives such as the need for recognition of their achievements and performance (Vanden et al. 2004). Thus the directors' role is to counsel and advice rather than to monitor the stewardship theory holds that no inherent, general problem of executive motivation exists. The model of man is based on a steward whose behavior is pro-organizational and collectivistic.

Following the basic thoughts of stewardship theory, there is no need of implementing monitoring mechanisms. There is no need of engaging audit services in order to secure the reliability of information. However, within stewardship theory an audit could be of value as a means of assisting the executive's stewardship.

#### **5) Stakeholder theory**

Stakeholder theory explains the relationship between organizations and their external environment (Freeman 1984). A stakeholder is defined as a human agency that can have an impact or affect organizations (Gray et al. 1996). Stakeholders represent the big umbrella for all individuals and parties that may have a direct or indirect interest in an organization.

Direct stakeholders are shareholders, employees, investors, customers and suppliers whose interests are aligned with the company. An example of an indirect stakeholder is the government, which is indirectly affected by the company's function (Kiel & Nicholson 2003). Due to this role of stockholders, organizations are not only accountable to shareholders only but also to stakeholders.

### **2.1.2 Objective of Tax Audit**

The overall objective is to improve the compliance of taxpayer's whether they declare the correct amount of tax and paid at the right time .the expectation by a taxpayer of an audit should have a deterrent effect and encourage the taxpayer to declare as far as possible a credible tax return .it also improves the taxpayer's understanding and awareness of the relevant taxes. (ERCA, 2014)

The main purposes of tax audit in ERCA are:-

- establish the extent of a risk or risks and quantify any errors which may have arisen as a result
- Improve future compliance
- Support those who wish to comply
- Deter non-compliance

### **2.1.3 Condition for Good Tax Audit**

For the tax inspector to carry out a good audit exercise, the following conditions must be fulfilled.(ERCA, 2014)

- 1) The tax auditor must be familiar with the environment in which he works. It is a condition which is highly critical that the tax inspector must be properly schooled in the political, economic, social, cultural and religious environment of the taxpayer. A good knowledge of his environment will affect the decision made by him.
- 2) The tax officials should be motivated to carry out tax audit, he should be properly trained and have experience in his area. The tax inspector should not be carried away by corrupt practices that render the aim of the tax audit useless.
- 3) The tax audit should be properly supervised by those who are professional and when new tax inspectors are sent to carry out the audit, they should be monitored by older ones so as to make sure that the right thing is done.
- 4) Specialization should be encouraged. The cases should be grouped. This will allow the tax audit staff to become specialist in specific field.
- 5) The manner in which the audit is being carried out should be changed. The use of computer should replace the manual process as this will go a long way in facilitating the job and helping to preserve information for a long time. This will improve the efficiency of the exercise (Ogundele, 1999).

### **2.1.4 Types of audit**

The types of audits are defined by the three major factors, namely:- (ERCA,2014)

- a) The audit scope and intensity
- b) The period(s) under examination
- c) The location of the audit activity

The major types of audit in ERCA are described below:-

**Comprehensive audit:-**is all encompassing in scope and entails an in depth examination of all information relevant to the calculation of a taxpayer's tax liability for all tax type for a given period. Given the broad scope, comprehensive audit is typically costly to undertake in terms of time and resources, and thus reduces the rate coverage of taxpayers that could otherwise be audited.

Comprehensive audit is classified into very complex, complex and simple. This classification will depend on a number of factors ranging from size, group, trade or profession, volume of records or transactions, nature of business to location. In practice the scope and nature of any comprehensive audit activity to be undertaken will depend on the available evidence pointing to the likely risks of non-compliance and a taxpayer's history .an audit may also be classified and justified as complex or very complex because of the taxpayer's financial and/or business activities which are unusually complex.

**Issue audit:-**this is limited scope audit that may be confined to specific issues in tax return and /or a particular tax type. The objective here is to examine key potential risk areas of noncompliance .this type of audit is recommended because it consumes relatively fewer resources than comprehensive audits and allows for an increased coverage of the taxpayer population .the audit will normally focus on a single tax type, period or item. Where afield issue audit escalate the case into comprehensive audit, the team coordinator's concurrence must be sought and the procedures for comprehensive audits adhered to .issue audits may be conducted either on the desk or in the field:-

- 1) **Desk issue audit:-**this can be conducted in relation to specific issue(s) of a taxpayer or enterprise when the auditor is confident that all the necessary information can be ascertained by conducting an examination in the office. All the required or relevant

information or data may be accessed from internal sources or official reference without the need to contact the taxpayer.

- 2) **Field issue audit**:-this is the escalation of a desk audit into a field activity or exercise .it is important to remember that the audit is limited to key issues of compliance or to a tax type or period. Field issue audit is commonly used in examining whether a taxpayer has met his/her obligation in respect of vat/tot and excise tax, withholding tax or income tax normally for a specified tax period.

Care should always be taken to guard against being derails and thus progressing field issue audits into comprehensive audits. The objective of the field issue audit is to focus on a shorter period for a single tax item for a faster and effective outcome. This audit type should therefore be the commonest and most effective audit type to be utilized for faster results.

- 3) **Desk audit**:-is used as preliminary examination of declarations analyzing accuracy, completeness, and ratios and crosschecking information to determine if further audit or investigation is warranted.
- 4) **Special audit projects**:-audits can be organized as a separate project for a targeted or specific group of tax payer's in a given period to verify compliance in the sector. These audit projects may cover an industry, trade, profession or a line of business. This will consist of specific checks and are used to address a particular risk or to establish the degree of non-compliance in a particular sector, industry or trade. For this audit type to be effective, all taxpayers in the targeted sector must be considered and handled with in the shortest time possible.
- 5) **Advisory visit audits**:-all registered tax payers or business need to be visited with the aim of offering advice on tax obligation and the taxpayers rights, and any other development pertinent to the tax system and administration .it is highly recommended that auditors carry out these audits to keep abreast with compliance trends of their

taxpayers and offer timely advise so as to improve compliance. These audits are expected to be spontaneous and hence should not take more than a day.

- 6) **Refund audits:**-this is a verification of a taxpayer's claim for a tax refund prior to processing the refund. The predominant claim for refund is vat and/or withholding which is submitted monthly.
- 7) **Investigation audit:**-involve the most serious cases of non-compliance with criminal implications. Require special skills in investigation and evidentiary requirements as they often involve seizure of records, taking testimonies from witness and preparing briefs for courts.
- 8) **De-registration audits:**-in order to establish outstanding obligations or liabilities, de-registration audit will be conducted for all reported cases of cessation of business, winding up or uncertainty .the audit will focus on determining taxes due and any other pertinent issues. The objective of deregistration audit is to ensure orderly exit from the tax register with the attendant obligations and liabilities sorted out.

### **2.1.5 The effective tax audit program**

Tax audit is one of the longest standing and accepted compliance strategies in tax administration. The tax audit program provides visibility to the compliance and enforcement arm of the tax administration (Thomson 2008). The auditing and spot-checking of records, coupled with a system of adequate penalties for detected cases of fraud, is the universal method for tax control and the prevention of tax evasion. Tax evasion can be brought to light only by a means of an effective audit program (Tait 1988). Tax audit also helps tax agencies to achieve revenue objectives that ensure the fiscal health of the country and individual states. It derives voluntary compliance and generates additional tax collections, both of which help tax agencies to reduce the tax gap between the taxes due and the amount collected (Barreca & Ramachandran 2004).

Furthermore, a well-structured tax audit program can provide valuable support in gathering information on the health of the tax system (including patterns of taxpayers' compliance

behavior), educating taxpayers (improving future compliance), and identifying areas of the tax law that require clarification or addressing deficiencies in the law (OECD 2006a). Accurate and timely self-assessment and compliance with tax by taxpayers is achieved only through highly visible and effective audit programs, including the consistent application of strong sanctions where noncompliance is encountered. Taxpayers must feel that there is a good chance that unreported liabilities and other forms of non-compliance have been detected during an audit (Biber 2010).

When an audit program is ineffective, it may result in the deterioration of tax compliance and a loss of credibility of the tax administration. Taxpayers may not be deterred from minimizing their tax liabilities if they believe that there is a little chance of being audited (Ebrill et al. 2001). Ebrill noted that there are several reasons for ineffective audit programs that are evident in varying degrees in several countries (Ebrill et al. 2001). First, audit typically requires higher level of skills than those needed for most other tax administration tasks, and such skills are sometimes in short supply. Second, the possibility of collusion between taxpayers and tax officials is significant during an audit. Moreover, auditors' errors may damage business activity that makes governments reluctant to support comprehensive audit programs.

The development of an effective tax audit program typically addresses coverage (percentage of taxpayers to be audited), selection of audit cases, methods (types of audits to be performed, duration of audit, approaches taken by auditors), staffing and training (staff resources needed to implement the audit program and the training provided for them), and monitoring activities (Ebrill et al. 2001).

A good audit program employs strategies to optimize both the direct and the deterrent effects of audits. The first can be achieved by auditing a higher percentage of the large taxpayers (Biber 2010). Although the frequency of audit is a contentious issue, the judgment is always a delicate balance between the cost of audit to check the temptation to evade and the cost. Where the tax system is fairly well established, audits of 15 percent to 20 percent of registered traders a year are sufficient. However, it is not only the crude number of audits that is the most useful measure of need (Tait 1988). In the case of VAT, effective VAT audit program should cover a 25 to 30 percent of the taxpayers each year (Ebrill et al. 2001). In addition, VAT audit need to be closely

coordinated with other tax liabilities especially income tax. Since most countries have integrated VAT and income tax administrations, the development of an effective VAT audit program significantly improves income tax compliance.

The deterrent effect is best achieved by extending the program to as many taxpayers as possible at all levels (Tait 1988). Through adequate audit strategy, tax administrations must foster, and not simply enforce, tax compliance. Tax compliance can be facilitated through improving services to taxpayers by providing them with clear instructions, understandable forms, and assistance and information as necessary. Monitoring compliance requires information systems as well as appropriate procedures to detect non-compliance (EC 2006). Voluntary compliance is generally enhanced by increasing the number of taxpayers audited than by auditing fewer taxpayers with large tax potential. Perversely, revenue is increased by concentrating on those taxpayers where a large amount of revenue is at risk. But there should be a careful planning when there is a widespread belief that most tax returns are underreported, otherwise there may be an over selection of returns for audit, with the result that the inventory of work in process may increase to unmanageable proportions and make an orderly approach to an annual audit work plan impossible (Tait 1988).

Thus, the actual number of audits planned should depend on the audit resources available to the program. The international standards as to the total staff assigned to audit should be close to 40 percent of the total staff of the tax administrations (Biber 2010). Further, audit capacities of field offices are determined by calculating the number of returns that can be audited. The calculation made using estimates of the number of returns each tax auditor can reasonably be expected to complete during a given audit period. There should be an over selection of 25 percent to 30 percent of audit capacity (Tait 1988).

With proper audit planning, strong supervision, and effective use of the review staff as a training vehicle, it is not unreasonable to expect an office auditor to complete an average of 10 to 20 cases a month, and for a field auditor (exclusive of auditors dealing with controlled cases) to complete an average of 4 to 6 cases a month. Allocation of about 200 cases a year should be reasonable for experienced junior auditors, who should be eligible for advancement to senior auditor after four years of satisfactory service in that grade (Tait 1988).

Therefore, planning an adequate audit strategy is a key success factor in post-fraud detection (where audits are intended to detect tax evasion and fraudulent claims) as well as proactively preventing tax frauds and evasions (Gupta and Nagadevara undated). Effective planning is required to ensure that the audit program is adequately developed to: (1) focus on and address the most significant risks; (2) target noncompliant taxpayers and not harass compliant taxpayers; (3) make optimal use of limited resources, and (4) influence compliance across the broader taxpayer community (Biber 2010).

The most effective VAT audit programs are those developed within an overall risk-management framework, and marked by the following design features and principles (Hellenstein 2005) and, (Harrison & Krelove 2005):

- A broad coverage of taxpayer groups (by size and sector) and compliance issues;
- Audit resources spread across all elements of the program. This ensures that a disproportionate share is not absorbed in verifying refund claims prior to payment;
- Pre-refund audits limited to only high-risk cases. Lower-risk claims are subjected to selective post-refund audits;
- VAT audits those are primarily short and limited to one or two tax periods;
- Audits of accounting systems rather than individual transaction checking, especially with large taxpayers;
- VAT audit program should have close coordination with audit programs of other taxes, particularly income tax;
- Consistent application of appropriate penalties for noncompliance; and
- Investigation of cases involving serious fraud with a view to prosecution under the criminal code.

Audit plan provides a path to follow to ensure that the audit is performed effectively and efficiently (OECD 2006a). However, it should not be treated as set in stone once created. Case planning must be a flexible tool and the original audit plan

should be reviewed and updated regularly during the course of the audit. Thus, characteristics of effective audit plans are:

- Flexibility to allow for unusual audit issues, adequacy of internal controls and the adequacy of books and records;
- Alignment with any quality assurance framework; and
- A clear focus, with potential areas of concern noted during the preliminary review and audit procedures selected that can address the concerns identified.

### **2.1.6 Audit case Selection method**

The primary goal of revenue authorities is to manage and improve overall compliance with the tax laws, and in the process sustain confidence in the tax system and its administration. Tax audit is a sole treatment for compliance risk available to administrations that allows exercising effective sanctions (imprisonment and penalties and/or interest). It acts as a public sanction making the extent of the administration's enforcement powers visible within the community and encouraging others to comply. Compliance risk is the failure to comply with the tax law by taxpayers whether due to their ignorance, carelessness, recklessness, deliberate evasion, or weaknesses in tax administration itself, and have been addressed only by enforcement through an audit-based approach (OECD 2004a).

However, tax administrations do not have sufficient resources to perform thorough on-site audits of the activities of all taxpayers or comprehensive crosschecking of all invoices or transactions. Tax administration, with limited resources and relatively large numbers of taxpayers to administer (especially in the small and medium enterprises), must design the audit program to deploy audit resources in a risk-based way with a view to achieve the most possible compliance and revenue objective (Thomson 2008 and OECD 2004a).

Accordingly, the first key to successful audit is the case selection methodology. It is critical to select audit candidates consistent with program objectives. Whatever the audit objectives have, the ability to narrow the pasture of potential audit candidates is necessary to achieve program objectives and optimal use of audit resources. Regardless of how automated and efficient the

audit process, audit effectiveness would not be realized under the selection of inappropriate audit candidates (Milack undated). Hence, managing an effective auditing program involves decisions as to the selection of best audit case strategy or combination of strategies. The selection strategies may vary by tax type. It may be based on either reported tax amounts or the industry type (Barreca & Ramachandran 2004).

Case selection through the use of risk management techniques is necessary to ensure that the audit program is fully in line with the administration's compliance strategy, and to set up the necessary audit trails to show why cases have, and have not, been made the subject of an audit (OECD 2006a). The most effective systems utilize taxpayer profiles and criteria to identify the highest risks for the revenue. These systems are frequently based on the crosschecking of internal information (Ebrill et al. 2001).

In tax administration, a risk is anything that can negatively affect the administration's ability to achieve its compliance and revenue objectives. Risk management is a formalized and systematic approach, based on sound analysis, designed to set the best course of action under the uncertainty of risk. The technique involves identifying, assessing, understanding, and acting on risks that impinge on the organization's ability to achieve its objectives (Thomson 2008). Risk management starts with risk identification, which includes a rough estimation of the risk related tax gap, the number of taxpayers involved and possible relations with other risk areas (EC 2006).

The tax gap (the potential tax yield minus the actual tax revenues) reflects the financial extent of the risk field. Although the determination of the tax gap is not easy, a rough estimation is usually done. The calculated gap can be further broken down into areas such as barely legitimate tax avoidance, fraud, serious noncompliance, error, and debt. This provides additional information on areas of risks that should be addressed. Strictly theoretical, the sum of the aforementioned individual risks identified must be equal to the entire tax gap (EC 2006 and EC 2010).

Compliance risk reduces tax yield, and can be categorized as register risk, filing risk, payment risk, and declaration risk. This classification makes tax administration in a stronger position to determine the appropriate treatment technique (EC 2010) and (Thomson 2008).

Register risk includes reduction of tax yield because ineligible taxpayers for tax registration become registered and/or remain registered when eligibility ceases, fail to register by those that fulfill registration requirements, and registration with erroneous information. Payment risk and filing risk are closely related but they should be analyzed separately since the treatments may vary. Payment risk is non-payment of amounts due on tax returns and assessments where as filing risk is failure of taxpayers to file their returns by the due date. In order to provide the correct preventive and corrective treatments there is a need to be able to target those taxpayers likely to file their returns late, or not at all. Finally, declaration risk is a risk that the amounts shown on the tax return are incorrect by error or deliberate act, and many tax administrations traditionally concentrated on this risk area with the intention of determining which cases should be selected for conducting audit activity (EC 2006 and EC 2010).

In addition to compliance risk identification, in an efficient audit management structure, there are pre-audit case management factors that need to be recognized to assure the taxpayers in that the burden of audits not fall disproportionately on any segment. These include inappropriate auditors' contact with taxpayers, audit cycle or enquiry window, materiality, and collectability.

**Inappropriate auditors:** It is useful to have regulations to preclude individual auditors from repeatedly auditing the same taxpayer, and to require an auditor to exclude itself from taking up an audit where they are acquainted with the taxpayer selected for audit. Such rules protect both auditor and the customer from the danger of such inappropriate contacts. The policy of repetitive audit procedures (RAP) may be used which holds that if a taxpayer is audited for non-business issues only (similar to an audit aspect) for the current year and the audit results in no additional taxes owed, the taxpayer is granted relief from audit for the next two years if no substantial changes take place. The intent is to eliminate non-productive and time-consuming audits for tax authorities, and to reduce the hardship associated with repetitive audits for fully compliant taxpayers (OECD 2006a).

**Audit cycle or enquiry window:** Regulations may be established to require that all audits must be started or completed within a predetermined timeframe. However, it gives certainty to taxpayers that after some period of time the danger of audit may pass. Thus, it needs to be supported

by powers of discovery to overturn the enquiry window where substantial tax fraud is found (OECD 2006a).

**Materiality:** Although a noncompliant high-risk item may be selected for audit, the materiality of the projected tax consequence versus the auditor's labor cost of pursuing the high-risk item may override the non-compliance aspect (OECD 2006a).

**Collectability:** The collectability concept implies that a taxpayer's inability to pay a future proposed tax assessment would be sufficient basis for not conducting the audit. Those administrations that do not use this concept report that collectability is a secondary objective and should not diminish the primary objective of a correct assessment of tax liability. In addition, the limitation of collectability considerations to the current tax period may not provide a complete financial picture for the taxpayer as it excludes consideration of future payment potential (OECD 2006a).

Apart from the above pre-audit case management factors, there are two key elements necessary in effective translation of strategic priorities for risk treatments in to individual case selections for action; (1) accurate and timely data and information relevant to the compliance risks to be addressed, and (2) knowledge management and analysis techniques to analyze the base data and facilitate feedback in to the compliance risk management process. Here, the main requirement is access to the data contained within individual tax returns. The essential information to case selection comes from previous case histories of the taxpayer concerned, information from third parties which can confirm the details shown on the tax return, and more generic taxpayer (business sector profile) (OECD 2004a).

Once required data accessed, some form of case analysis methods should be used to analyze the base data for selecting cases. Audit selection methods range from simple random selection to more complex rule-based selection, sophisticated statistical and data mining techniques. Selection strategies can vary by tax type, and even within a single type (Barreca & Ramachandran 2004).

The common case selection methods include random selection of cases, screening or case review by auditors, rule base and automated risk scoring systems, and data mining and statistical analysis.

**Random selection:** It has no bias in audit case selection, and useful to fight corruption. This method is perceived as fair by taxpayers. However, it clearly not focused on highest risks, may have high opportunity cost if used as sole case selection method (Vellutini 2010). As Gupta (undated) noted, simple random selection has a major drawback in that both honest and dishonest taxpayers are equally treated since probability selection give equal chance of being selected for both. However, the criteria or information based selection system too has a drawback in that it presupposes certain clue of noncompliance, which may actually be sign of other things such as change in economic condition in that particular trade.

**Screening or case review by auditors:** It is the traditional method by which audit cases have been selected, and dates from the time when there was little or no IT support, the data available was in any case limited, and the compliance risk management techniques at a strategic level less well developed. Such a methodology has a benefit that it makes full use of local knowledge, creates significantly less caseworkers resistance, can be used to attack specifically defined risks and can be operated substantially without IT support (OECD 2004a and OECD 2004b). Manual selection of audit cases is based on the auditors own knowledge of the taxpayers’ behavior and environment. However, it cannot find out patterns of noncompliance hidden in the history of noncompliance in the same area, sector, or as determined by other taxpayer attributes. It also favors rent seeking and corruption in the tax administration since it is discretionary and subjective approach (Vellutini 2010).

The challenges inherent in relying on caseworker selection are: it relies on a limited data set with no systematic cross reference to other data available within the administration’s system; caseworkers regardless of their experience can miss aspects of noncompliance with which they are non-familiar; those with the knowledge to undertake such screening are usually those with the skills to undertake the substantive intervention. Thus, there is an opportunity cost in asking them to undertake such screening. Modern standards of propriety indicate that there should be a gap between those selecting cases and those functioning cases (OECD 2004a).

**Rule base and automated risk scoring systems:** It allows for the bulk processing and risk assessment of returns data. The data is reviewed against a set of risk indicators and the results be ranked in terms of the risk of noncompliance identified. Such system is an essential tool in facilitating the exclusion of bulk of returns with no or very low identified risks and allowing the resources for risk identification to concentrate their efforts only on those cases with significant identified risks (OECD 2004a).

However, this system has its own inherent challenges. First, many of the rules by which a case is scored are dependent on financial ratio analysis and other industry benchmarking that can be changed overtime. The rules also may be, in themselves, standard factors to be achieved when they become known within the population. Thus, attention needs to be given to continually update the risk rules.

Second, the rules need to be responsive to the local knowledge of the front line staff who is working on the cases when selected. Final case selections need to be able to reflect the local knowledge of the caseworkers themselves whilst retaining appropriate propriety within the case selection system. Automated selections with no opportunity to be influenced such local knowledge can create resistance and lead to suboptimal working once the cases are underway. In addition, the risk rules need to be responsive to the knowledge gained by front line workers from working their cases. Such knowledge can be about new risks, changes in commercial behaviors, or new technical tax devices and the impact of that knowledge can be significantly leveraged if it can be captured within a flexible and developing set of risk rules.

Third, the rules should bring together from dissimilar sources such as tax returns, third party information, and public domain information from internet. This level of analysis requires considerable investment in IT resources. Finally, the rules need to have the capability to be changed reasonably and quickly to take in to account new strategic appreciation of compliance risk. Once again, if the rules are themselves hardwired in to IT coding then this may be a resource intensive business (OECD 2004a).

**Data mining and statistical analysis:** It is becoming increasingly common to base case selection methodologies on the results from statistical analysis. Data mining is the exploration and analysis of large quantities of data in order to discover meaningful patterns and rules

(Barreca & Ramachandran 2004). Organizations use this information to detect existing fraud and noncompliance, and to prevent future occurrences. The use of data mining techniques identifies patterns of noncompliance in the past and those characteristics in the current population. It enables organizations to leverage their data to understand, analyze, and predict noncompliant behavior.

However, data mining requires significant investments in IT both hardware and software, and it may be difficult to acquire accurate data on which IT programs can operate. It is a difficult road to go down when electronic infrastructure do not support such investments or the skills are not available to the tax administration (OECD 2004a).

Statistical analysis is often used to examine taxpayer data and to find the correlation between the data and non-compliance. It typically involves using prior tax audits results, which are then analyzed in conjunction with taxpayer data (OECD 2004b).

### **2.1.7. Examination techniques**

A tax auditor applies various techniques to examine the books and records behind a return. The techniques to be used depend on the taxpayer and the tax regime concerned. An effective case plan can be cognizant of a range of investigative and analytical approaches that may vary depending upon the area of risk and the circumstances of the particular taxpayer. The decision regarding the type of tests to be undertaken as well as the records needed by the auditor to address specific issues is influenced by the nature of the taxpayer's operations, adequacy of books and records, and materiality of potential adjustments (Biber 2010).

The techniques used for audit examination purposes include analytical review, investigative approach, field examination, record examination, and counterpart examination (OECD 2006a).

**Analytical review:** An analytical review of financial statements and returns are often completed during the preliminary stages of the audit. Ratios, such as gross profit and inventory turnover, are used to test the accuracy of taxpayers' reported sales, cost of sales, or ending inventory. The unusual variances (abnormal deviation of calculated ratios from the previous experience) are noted and addressed during the interview with the taxpayer and additional audit procedures developed where necessary.

**Investigative approach:** Auditors are encouraged to use an investigative approach in their audits. Such an approach uses information obtained through observation, discussion, documents or records obtained from either the taxpayer or other sources. It requires judgment, imagination and using information outside the accounting records to perform the audit.

**Field examination:** This is utilized when information gathered on significant events such as underhand trade, disguised transaction and other data concerning transactions. The examination also include on sight survey of the current conditions of the taxpayer's business through physical checks of original transaction records and vouchers, assets and liabilities and other aspects of the business.

**Record examination:** The main approaches to detect false accounting include the examination of books and documents conducted at the taxpayer's business office or branches, counterpart examinations and examination of savings and deposit accounts.

**Counterpart examination:** It is an examination performed based on third party information where warranted. Information can be obtained during the course of an audit from third parties to verify the taxpayer's income (OECD 2006a), for example:

- Financial institutions and public companies information on interest and dividends matched with what taxpayers report in their tax return;
- Information from Government regarding social benefit payments, and employer information concerning salary and wages paid and tax deducted, both for income and non-monetary benefits; and
- Matching foreign source income.

### **2.1.8. Audit workforce capabilities**

Revenue bodies must manage and develop their audit workforce to deliver their planned outcomes through increasingly designing and implementing capability or competency models. Capability or competency model refers to a formal specification of the skills, knowledge and attributes of staff that are required to perform a specific job in an efficient and effective manner.

The model generally contains job descriptions, functional descriptions, and competency profiles using task-related competencies. It is typically supported by training, exams, and educational requirements to ensure and build capability. The model is used as a basis for managing performance, training, staff development, and recruitment across the audit function (OECD 2006a).

Different capabilities are required for work performed in different market segments, or on clients exhibiting different behaviors towards tax compliance. Typical points of difference are capabilities required for noncompliant aggressive clients, audit work with large businesses (deeper and more specialized knowledge about specific regulations is required for this segment), performing system and electronic data base audits, and conducting criminal and fraud cases (OECD 2006b).

**Required capability:** The required capabilities of auditors are generally identified by analyzing the activities required to perform particular audit tasks, and through practice and experience. In addition to their primary role of detecting and deterring noncompliance, tax auditors are often required to interpret complex tax laws and conduct intensive examinations of taxpayers' books and records. Hence, revenue bodies pay close attention to the overall management of the tax audit function, and particularly to the strategies and methods used for recruiting, developing and managing individual audit staff (OECD 2006a).

Thus, tax auditors should have a capability to: conduct investigations, determine compliance, tax accounting and financial analysis, conduct research and analysis, make effective decisions under the law, effective communication, apply work processes and procedures, and manage own work and relationships (OECD 2006b)

In addition to the required core capabilities, greater attention and emphasis is needed on soft skills and other attributes. These include behavioral and motivational competencies, personal attributes such as work and integrity, feeling for the detection of fraud and irregularities, observe and detect relevant indicators in surroundings, identifies patterns and describes their significance to the situation, and effective observational skills. Familiarity with basic accounting, bookkeeping, and business and industry practices is also generally expected for all staff (OECD 2006b).

Moreover, the required capabilities of audit managers and directors are typically identified based on the notion of coaching, communication, and leadership skills. The required capabilities for audit managers and directors often focused on leadership and management skills, technical expertise, advanced audit skills, achievement orientation, ability to develop and coach others, high level communication skills, and ability to make strategic decisions (OECD 2006b).

**Competency assessment** It is important for tax administrations to assess and evaluate the competencies of their staff. The direct manager commonly performs competency assessments during recruitment and promotional processes on an annual or semiannual basis for those staff maintaining current positions (OECD 2006a). Assessments performed as part of recruitment processes are often performed by external specialists, human resource departments and/or panels of internal subject matter experts. Other events triggering capability assessments include prior to performing a new type of work, prior to starting a new role, and ongoing informal assessments and learning and development activities (OECD 2006b).

Assessment methods used include knowledge-based assessments administered online, formal tests and exams to attain a recognized qualification, peer reviews, a tutor to support and assess newly hired staff, and technical evaluations. The measurement and tracking process of the audit workforce provides management with tangible information of the resource and capability mix or trends across the whole audit workforce, providing valuable data for workforce and succession planning. Many revenue bodies indirectly attain a measure of the competency level of their audit workforce by considering: key performance indicators and results, quality assurance results, client or professionalism survey results, quantity of audits performed, training course and other assessment results (OECD 2006a).

Further, tax administrations may record the skills (including qualifications) and areas of expertise of individual staff. Using and sharing this information across the organization, tax administrations may better allocate work and identify specialist resources or skills (OECD 2006b).

**Improving competency and addressing capability gaps** Responsibility and accountability for improving auditors, audit managers and audit directors commonly lies with the staff member in

question and their direct manager and/or local management team. Competency improvement should be integrated (not be seen as extra task) into normal business activities. Together with tax auditing or training departments, human resource departments (where applicable) often have joint responsibility and be significant contributors to the improvement process (OECD 2006a).

Revenue bodies may develop staff and address capability gaps through recruitment processes and the use of programs such as training and development programs, mentoring and coaching programs, accreditation models, job rotation and/or placement programs, career paths, knowledge sharing initiatives and knowledge tests. Capability gaps are typically gathered from various sources including quality management system results, performance system interviews and appraisals, client professionalism, satisfaction and other similar surveys, and training program evaluations (OECD 2006b).

Tax administrations must recruit audit staff specifically to carry out tax audits. To attract the right staff in increasingly competitive and skilled labor markets, effective recruitment policies are essential. Audit staffs are generally recruited either fully trained so they can be effective in post very quickly, or selected because they have strong potential to become auditors through in-house training and education. A minimum standard of specific academic qualifications, such as a diploma or degree or being a chartered accountant, is often required for some grades of audit staff. There is also an assessment of applicants against competencies relevant to their audit work in the areas of problem solving, analytical skills, interpersonal skills, self-management, decision making and oral and written communications. Further, all auditors required to have computer skills with other more specialized skills, such as legal experience or specific types of tax knowledge being needed for posts that are more technical (OECD 2006a).

In order to maintain standards of auditing it is essential that auditors are given both initial training (classroom and on-the-job instruction) to bring auditors up to the required level, and continued training so that their skills are kept up to date and relevant. The extent and nature of this training and the balance between the two varies according to need, and relates to the recruitment and development policies adopted. Initial training varies depending on the level of qualifications and experience expected of new recruits. For instance, recruit staff without professional qualifications need much more extensive initial training in tax law and auditing, in-

house testing is generally used to confirm that trainees reach the required standard (OECD 2006a).

To deliver ongoing training and development, a number of methods are used including training courses, computer based training packages, memos, guidance notes, self-study packs, facilitated workshops and discussion forums, on-the-job training, coaching and mentoring, and virtual university and learning tools. As a rule, continuing professional training is not normally examinable and the amount of training undertaken varies between countries and over time (OECD 2006a).

### **2.1.9 Record Keeping Requirement**

All persons who are engaged in a business or trade or who own buildings held all or in part for rental, except for Category “C” taxpayers shall keep books and records. Those businesses that are required to keep books of accounts and records are also required to keep the following information:

- Record of the business assets and liabilities, including a register of fixed assets showing the date of acquisition, the cost of acquisition, and the current book value of each asset;
- Record of all daily income and expenses related to the business activity and the matter to which they relate;
- Record of all purchases and sales of goods and services to the business activity showing:
  - The particular goods and services sold;
  - The name of the buyers and sellers or providers in such a manner that they can be identified by the Tax
- Authorities pre-numbered invoices containing the vendor’s tax identification number
- Record of trading stock on hand at the end of the accounting period, including the type, quantity and cost of that stock as well as the method of valuation of that stock;
- Any other document relevant for the determination of the tax liability;

- If a taxpayer has certain books or records in a foreign language, the Tax Authority may require that they be translated into one of the official languages of Ethiopia at the taxpayer's expense (proclamation no.286/2002).

## **2.2. Empirical Studies**

This section reviews the empirical evidence on tax audit effectiveness and factors affecting it.

Eden & Moriah, assigned 224 organizations to experimental conditions (audited or not audited) and monitored their performance for a year. Their findings showed that performance significantly improved during the half year following the audit in the experimental branches, while the control branches experienced a decline due to poor general business conditions. It should be reiterated that Eden & Moriah are nearly alone in developing and testing an explanatory model of IA effectiveness. While that study offers a useful jumping-off point for understanding how good auditing can improve a company's performance, it does not go far enough in explaining when and why IA works, and the conditions that facilitate or impede it. Helping to bridge this gap will be one of the main contributions of this study (Eden and Moriah, 1996).

There are main approaches to the concept of IA effectiveness. According to the first approach, the effectiveness of internal auditing is determined by the fit between the audit and some set of universal standards extrapolated from the characteristics of audit. Such an approach was presented by Sayag, who advanced five standards for internal auditing: interdependence, professional proficiency, and the scope of work, the performance of the audit and management of the internal audit department (Sayag, 2010). This approach requires the development of systematic and generally valid measures by which to gauge IA effectiveness (Dittenhofer, 2001). One of the early efforts in this regard is that of who designed a questionnaire designed to elicit managerial feedback for each internal auditing activity in an organization. The questionnaire covered four issues: planning and preparation; the quality of the audit report; the timing of the audit; and the quality of communication between the relevant actors. Based on managers' responses, an average score was calculated for the effectiveness of a given auditing task.

In a study sponsored by the Institute of internal auditors (IIA), identified 15 criteria used by 13 large private organizations to evaluate the effectiveness of internal auditing. They concluded that effectiveness is determined mainly by the fit between the auditing work and the goals set by managers, the qualifications of the internal auditor, management support for the internal auditing staff, and several characteristics of the internal auditing department. The previous study identified 15 factors that contribute to an effective audit and categorized them into three stages of the auditing process: planning, fieldwork, and reporting and review. They suggested measurements they considered valid and reliable for these factors. Moreover, Ziegenfuss, developed a questionnaire that includes 84 criteria for effectiveness categorized into four main areas: the environment of the internal audit, input into the audit, the auditing process and the output of the audit (Ziegenfuss, 2000).

Appelgren studied the effect of information regarding different audit strategies on taxpayers' compliance behavior in Sweden. The study was conducted with the intent of examining whether the taxpayers in reality behave as expected by theory of tax audit. Experimental design was used to test the effect of information regarding different audit strategies on taxpayers' compliance behavior. The experiment was measured as the change in declared income between years, and was conducted in 2003-04 on approximately 900 sole proprietors which are divided into three groups (rational group, random group and control group) each with around 300 firms. The rational group members were informed that audit would focus on taxpayers declaring lowest income. The random group was told that audit would be at random whereas the control group 36 members received no information. Further, the sample was limited to men below the age of 55 in order to concentrate on a high-risk group (younger men are more fraudulent than women and older men). The principal finding of this study was that declared income increased significantly more in rational audit strategy group than in the control group. The results of the study indicate strongly that information concerning the use of rational audit strategies is superior to information concerning random audits, and that audit information, in general, is superior to no information. The information concerning the rational audit strategy reduces tax fraud compared to no information. According to this study, tax audits have an indirect deterred effect by which rational taxpayers adapt their behavior to the expected degree of auditing if they are made aware that they may be audited (Appelgren 2008).

Sayag studied the importance and relevance of a scientific examination of internal audit's effectiveness and its determinants. It is exploratory factor analysis and uses conceptual model of research. The target population was all Israeli organizations. From these questionnaires' were mailed to 292 organizations, only 108 were returned the questionnaire. Correlation analysis was applied first to determine the interrelationships among the research variables and to examine the possibility of multi-co linearity. Regression analysis was used to test the other hypotheses. The finding of the study shows that auditee's evaluations and the added contribution of internal audit were positive in the private sector, there is no significant correlations were found between the variables of professional proficiency and career advancement and auditing effectiveness ,greater quality of audit work and greater organizational independence were positively related to audit quality and auditee's evaluations.(the correlation is stronger in the case of organizational independence and perceived top management support was the only variable that was strongly and consistently related to three auditing effectiveness dimensions (Sayag, 2010).

Ratto, Argues that random audit programs provide income taxpayers with information that alters their perceptions of, and hence their behavioral response so, audits. Comparing samples of randomly selected audited and non-audited UK taxpayers, the evidence confirms predictions that audited taxpayers found to be □compliant□ reduce their subsequent compliance. The opposite response is observed for taxpayers found to be “noncompliant.” The results highlight the importance of testing separately the responses of taxpayers facing different opportunities and incentives to evade tax in order to avoid conflating their different effects, and to reveal both positive and negative indirect revenue effects from random auditing (Ratto, 2012).

Qtish examined the relationship between some components (i.e. risk assessment, control environment and control activities) of internal control system and the effectiveness of audit program in Jordan. Quantitative approach was incorporated in this study. Based on 43 usable questionnaires, the result of the study's how that the risk assessment does contribute significantly toward an effective audit program. On the other hand, the results of analysis indicate that control environment and control activities don't contribute significantly toward an effective audit program. These results give an indicator that Jordanian company's lack the necessary experience to deal with the current tools of internal control evaluation (Qtish, 2012).

The study of Adediran S.A. examined the impact of tax audit and investigations on revenue generation in Nigeria. The aim is to determine if tax audit and investigations can actually increase the revenue base of the government and if it can also stamp out the incidence of tax evasion. Data were collected through the primary sources from four hundred and ten respondents who are staff of the Federal Inland Revenue Service and Edo State Board of Internal Revenue. Hypotheses formulated were tested with Pearson Correlation Coefficient using SPSS output data. The findings are that Tax audit and investigations can increase the revenue base of the government and can also stamp out the incidents of tax evasion in the country. It was recommended that Tax audit and investigations should be carried out more often and as thorough as possible to accomplish its task of increasing the revenue base and stamping out tax evasion in the country(Adediran S. A, 2013).

The objective of Al Frijat study was to show the tasks to be performed by AIS in the income tax department to improve the effectiveness of tax audit and collection. The researcher uses descriptive analysis and quantitative analysis .data was collected through interviews with senior managers and review of previous articles and recent official reports of income tax authority. The finding of the study shows that the study found that the AIS used in the income tax department positively influenced the effectiveness of tax audit and collection due to the existence of qualified human resources, an advanced computer system and competent control system (Al\_Frijat, 2013).

Chatama examines how the use of ICT has modernized Tax administration procedures and improved revenue collection at Large Taxpayer Department of Tanzania Revenue Authority (Chatama, 2013). ICT was introduced into the department in 2001 for facilitating maintenance and timely access of records and fast processing of return so as to remove postal delays; minimize operational costs; curb cheating and plug revenue loss (TRA 2010e). Large Taxpayers and Large Taxpayer Department staff (100%) agree that, since 2001 time for processing return and responding to queries have been reasonably shortened (Victor–Nyambo 2009). TRA reports reveal that, actual revenue collection increased from TZS. 204,397.5 Millions in 2001/02 to TZS. 1,605,751.2 Millions in 2008/09 while revenue contribution share rose to 41% in 2008/09 from 23% in 2001/02. Although other factors in the economy like; increased internal trade, reduced importation and more reliance to home products may cause the increase, if there is no good tax

administration, revenue will not be reflected in collections. The fact that revenue has increased proves that, ICT use enhance better tax administration.

The study of Husam Al-Khaddash aims to analyze the Factors affecting the quality of Auditing: The Case of Jordanian Commercial Banks. Its general objective is to examine some factors affecting auditing quality in the Jordanian banks from internal and external auditor's perspective. Data was collected through questionnaire method; the number of observations (respondents) for each variable was 85. And analyzed using Statistical Package for Social Sciences (SPSS).as per finding of the study the following hypothesizes are accepted; - The internal control system doesn't affect auditing quality in the Jordanian banking sector; the independence of the auditor doesn't affect auditing quality in the Jordanian banking sector, the size of the auditing office doesn't affect auditing quality in the Jordanian banking sector and There are no differences in auditing quality between internal and external auditors. The following hypothesizes are rejected:- Auditor efficiency doesn't affect auditing quality in the Jordanian banking sector , The reputation of the auditing office doesn't affect auditing quality in the Jordanian banking sector, Auditing office fee doesn't affect auditing quality in the Jordanian banking sector and The specialty and proficiency of the auditor doesn't affect auditing quality in the Jordanian banking sector. The study finds that performance of tax revenue is relatively poor that accounts an average of 10.76 percent of GDP during the 2004/05 - 2008/09 fiscal years, which is caused by lack of voluntary compliance mainly due to paucity of taxpayers" awareness and the weakness in the tax administration itself, ineffective audit program in particular (Husam Al-Khaddash, 2013).

Dieu explore the role of financial statements audit in promoting tax revenues growth in Rwanda in the broader perspective. Survey questionnaires as primary data collection instruments were distributed to all audit officers of Rwanda Revenue Authority equaling to 100 staff and followed both analytical research design. Secondary data included reports from Rwanda revenue authority from 2006 to 2010.

The paper also examines preliminary empirical results on the relationship between financial statements audit and tax growth this paper supports the notion that the practices of audit of final books of accounts for both small and medium enterprises at institutional level are prerequisite for growth of tax revenues in the country. In conclusion, the results not only have the potential to

contribute theoretically to public finance but also to the area of institutional performance (Dieu, 2014).

Gwilliam assessed factors influencing internal audit effectiveness (IAE) in Saudi Arabia data were obtained from 203 managers and 239 internal auditors from 79 Saudi Arabian public sector organizations. Multiple regression analysis examines the association between IAE and five principal factors. Results suggest that management support for IAE drives perceived effectiveness of the internal audit function from both management's and the internal auditors' perspective. Management support is linked to hiring trained and experienced staff, providing sufficient resources, enhancing the relationship with external auditors, and having an independent internal audit department. Saudi Arabia is representative of many developed and developing environments, and its recent tradition of governance and audit is mirrored in countries worldwide. Moreover, its specific cultural traditions involving clan and tribal allegiances, and pervasive and core religious beliefs, characterize the GCC countries, the Arab World generally, and indeed, many other developing countries, irrespective of wealth. Thus, links between management support and internal Audit effectiveness are likely generalizable beyond the Saudi public sector context (Gwilliam, 2014).

Saidin examined the moderating effective audit committee on the relationship between audit experience and internal audit effectiveness in the public sector using the perception of internal auditors. Data of the study were collected through research assistant employed, in which 300 questionnaire were sent to internal auditors in the North West geo-political zone local government in Nigeria. The study used simple random sampling technique; data were analyzed using Statistical Package for Social Science (SPSS) version 20. Descriptive statistic, factor analysis, correlation matrix and finally, hierarchical multiple regression analysis were carried out. The result findings of the analysis revealed that, audit experience has a significant positive relationship with internal audit effectiveness and effective audit committee were significantly moderates such relationship (Saidin, 2014).

Anam Masood explored the antecedents behind ineffective audits at government level. The purpose of the study is exploratory and qualitative research approach has been used. The data has been collected from fifteen senior government auditors and It is a cross sectional study. In depth face to face interviews (which have 20 questions) were conducted with government auditors at

their workplace. Analysis of interviews has been presented through word tag cloud, word tree maps, and model and cluster analysis of node similarity and Pearson correlation coefficients of variables. Pearson correlation coefficients have been generated to determine the relationship between several antecedents and ineffective government audits. The finding of the study shows massive corruption, conservative auditing methods, lack of cooperation from auditee, low morale of auditors, lack of financial independence, lack of power to take action against malpractices, lack of financial, technological and human resources, lack of qualified trainers and ineffective training institutes are antecedents of ineffective audits which ultimately make it difficult to bring transparency and accountability in the public sector (Anam Masood, 2015).

George Drogalas study examined the relationship between tax audit effectiveness, tax legislation and the use of specialized information system tools. The study has two hypotheses; The extent of Information System (IS) effectiveness has a positive effect on Tax Auditing Effectiveness and The extent of Tax Legislation has a negative effect on Tax Audit Effectiveness. The research design is based on a questionnaire. Survey methodology is used as one of the most appropriate methods in the collection of primary data. Structured questionnaire was used. Over 200 questionnaires were sent to 205 tax auditors 93 complete questionnaires were returned, representing a response rate of 45.3 per cent. The data was analyzed with the use of the SPSS software. Factor Analysis and multiple regression analysis were employed in order to examine the hypotheses. The finding of the study shows that there is a positive and significant relationship between “Information Systems” and “Tax Infringements Tracking” and Tax Legislation” found be negative and significant associated with” Tax Infringements Tracking (George Drogalas, 2015) .

There are also studies on audit and the factors affecting it in Ethiopia: Yismaw studied how audit quality, management support, organizational setting, auditee attributes and the interplay among them, influence audit effectiveness in a public Sector organization. Data were collected via questionnaires distributed to internal audit personnel and an interview was conducted with the internal audit director. A review of relevant documents audit plans, audit programs, working papers, audit reports and audit manuals, all served as means of generating secondary data. The study was conducted on large public sector higher education institutions or university in Ethiopia with over 25,000 students. There are 14 auditors in the internal audit office of the university; the questionnaires’ were distributed to all the auditors. The findings of the study shows internal audit

effectiveness is strongly influenced by internal audit quality and management support and organizational setting and auditee attributes don't have a strong impact on audit effectiveness (Yismaw, 2007).

Yesegat adopted an in-depth interview conducted with tax officials and surveys of taxpayers and tax practitioners conducted using semi-structured questionnaires. The main findings of the study regarding VAT audit is that the VAT audit rate is low that may be due to resource constraints, and the cases subject to audit are selected by audit selection committee based on a criteria including credit declaration, non-filing and unusual filing patterns, nil VAT declaration, and information from third parties. The study further revealed that the quality auditors (VAT administrators at large) are poor to achieve efficient and effective audit program. Based on the survey results, the study stated that tax administrators are not capable of handling audit cases quickly, lack confidence to make decisions and not have willingness to help taxpayers. In addition, the tax authorities have no sufficient number of VAT administrative personnel, which comprise only 10.4 per cent as to the proportion of the total employees at the Ethiopia Federal Inland Revenue Authority (EFIRA) (Yesegat 2008).

The study by Gebeyehu was an attempt to trace out the basic concepts of tax audit, and analyze the significance and role of tax audit in increasing tax revenue and in strengthening tax administration capacity. The methods adopted include questionnaires (both open and close-ended), personal interviews, and document analysis by using documents such as published materials, annual reports, magazines and internet. The results of the study indicated that, in history, the highest ratio of tax to GDP in Ethiopia is 13 percent, which is registered in 2003/04. Most of the country's revenue is from non-tax sources such as grants. Revenue derived from taxes is dominated by indirect taxes. In general, the study mainly focused on the issues of personal income tax and business profit tax. The study stated that personal income tax does not need critical assessment other than checking whether the amount withhold by the employer is forwarded to the respective tax authority. Whereas, business profit tax needs much effort to levy and collect due to the high risk of understatement and evasion since most taxpayers use all mechanisms that could understate their tax liability. However, there is no sufficient and available statistics about the extent of assessment under the prevailing tax audit net. The type of tax audit

performed by tax auditors is only desk audit. So far, there is no field audit although the problem of tax evasion bothers revenue agencies at different levels (Gebeyehu, 2008).

The study of Getaneh examined the problems in tax audit practice in Ethiopia (the case of the federal government). The study was conducted to investigate the tax audit practice, and to identify the main problems of the tax audit program performed that affects tax revenue collection and taxpayers' voluntary compliance in the Ethiopian tax system. The study adopted both quantitative and qualitative approaches. Specifically, the techniques used in the study include survey with tax auditors and investigators, in-depth interviews with tax officials and taxpayers, and documentary analysis. (Getaneh, 2011)

Ayalew examined factors affecting tax audit effectiveness of the Bahirdar city revenue office. It uses quantitative method of research approach. Data was collected through survey of questionnaire analysis of revenue offices tax auditors and taxpayer's analysis, auditors and taxpayer's selected based on simple random sampling method of census and lottery method. The study selected 333 sample participants from a total of 1518 observations, from this 265 were returned. Data was then analyzed on quantitative basis using Pearson's correlation, linear regression analysis and descriptive statistics. The finding of the study shows that; there is no statistical significance negative relationship between auditee attributes and tax audit effectiveness, There is no statistical significance positive relationship among organizational setting, top management support and tax audit effectiveness and there is strongly significance positive relationship among audit quality, organizational independence and tax audit effectiveness (Ayalew, 2014).

BIBISSO assessed Tax audit practice of Hawassa city administration Revenue Authority. The author used mixed research approach and descriptive survey was employed, Questionnaire and interview were used to collect data Questionnaire and interview was designed to eleven tax auditors and seven Revenue Authority officials respectively. The result of the study revealed that the Revenue Authority of Hawassa city administration extensively use comprehensive types of audit. Audit coverage of the revenue authority was too low; audit cases were selected based on associated risk but not used the standard risk identification criteria as of BPR and The Authority was not perform the audit work in predetermine time. Generally the revenue authority was not performing tax audit according to the standards (BIBISSO, 2014).

Lielina assessed the audit quality determinant factors in Ethiopian manufacturing share companies. To collect the necessary data the study adopted structured review of documents. Data were analyzed through E-views 6 software package; the study selected a sample of twelve (12) companies for the period of five years (2009-2013) with the total of 60 observations. Then companies were selected based on simple random sampling method to avoid biases and represent firms within manufacturing companies. The results of panel least square regression analysis show that audit firm industry specialization and certified audit professionals ratio have statistically significant and positive relationship with manufacturing share companies' external audit quality. On the other hand, the joint provision of audit and non-audit service has a negative and statistically significant relationship with manufacturing share companies' external audit quality. However, the relationship for audit firm size and audit firm tenure is found to be statistically insignificant (Lielina, 2015).

### **2.3. Gap in Literature**

Even though plenty of studies discuss audit effectiveness in different countries worldwide ,the researcher have got access to studies held on Saudi Arabia, Israel, Nigeria , Tanzania ,Jordan and other few countries .In Ethiopia the study of (Gebeyehu,2008) ,( Getaneh,2011) and (BIBISSO, 2014) discuss tax audit practice of Addis Ababa city administration ,Federal government and Hawassa city administration respectively .on the other hand the study of Yismaw measures internal audit effectiveness by focusing on public sector organizations(Yismaw, 2007). While recently the study of Leilina discuss external audit quality by focusing on manufacturing share companies (Leilina, 2015) and Ayalew measures tax audit effectiveness of Bahirdar city administration revenue office(Ayalew, 2014). Those studies examine issues regarding tax audit effectiveness using different variables. But here in the current study the researcher focuses only on large tax payers.

However, to the knowledge of the researcher, it is possible to conclude that although there have been a number of studies on tax audit related issues both in developed and developing countries, Ethiopia in particular, there are no studies that exhaustively examine the tax audit practice. In Ethiopia, the two exceptions regarding tax audit issues are the study by Yesegat (2008) and

Gebeyehu (2008) which have been reviewed in the preceding section. Even these studies did not assess exhaustively all tax audit activities in Ethiopia. The study by Yesegat (2008) was specific to VAT, and mainly focused on administrative capability issues. The study by Gebeyehu (2008) was specific to income tax in Addis Ababa City administration, and mainly focused on the way of increasing government revenue. Getaneh (2011) examined tax audit practice problem the case of Federal Government focused on federal government. The study by Melat (2016) examined tax audit practice and its significance the of larger taxpayers□ branch office. Here the researcher wants to assess tax audit practice and its effectiveness in enhancing tax revenue. The main reason for selection of such category of taxpayers for audit purpose is their higher compliance risk and large tax potential .and also is highly influential in investment and other economic activities.

Based on these gaps in the literature together with the problems stated the following research question is established.

How do experience and capabilities of audit staff, tax payers record keeping, experience of tax payers accountant, effectiveness of information system, audit types used, audit case selection method and audit examination, audit rate used affect effectiveness of tax audit practice at large tax payers branch office ?

## **2.4 Conceptual Model**

### **Dependent Variable**

#### **2.4.1 Tax Audit Effectiveness**

Tax audit is one of the longest standing and accepted compliance strategies in tax administration. The tax audit program provides visibility to the compliance and enforcement arm of the tax administration (Thomson 2008). The auditing and spot-checking of records, coupled with a system of adequate penalties for detected cases of fraud, is the universal method for tax control and the prevention of tax evasion. Tax evasion can be brought to light only by a means of an effective audit program (Tait 1988). Tax audit also helps tax agencies to achieve revenue objectives that ensure the fiscal health of the country and individual states. It derives voluntary

compliance and generates additional tax collections, both of which help tax agencies to reduce the tax gap between the taxes due and the amount collected (Barreca & Ramachandran 2004). Furthermore, a well-structured tax audit program can provide valuable support in gathering information on the health of the tax system (including patterns of taxpayers' compliance behavior), educating taxpayers (improving future compliance), and identifying areas of the tax law that require clarification or addressing deficiencies in the law (OECD 2006a). Accurate and timely self-assessment and compliance with tax by taxpayers is achieved only through highly visible and effective audit programs, including the consistent application of strong sanctions where noncompliance is encountered. Taxpayers must feel that there is a good chance that unreported liabilities and other forms of non-compliance have been detected during an audit (Biber 2010).

When an audit program is ineffective, it may result in the deterioration of tax compliance and a loss of credibility of the tax administration. Taxpayers may not be deterred from minimizing their tax liabilities if they believe that there is a little chance of being audited (Ebrill et al. 2001). Ebrill et al. (2001) noted that there are several reasons for ineffective audit programs that are evident in varying degrees in several countries. First, audit typically requires higher level of skills than those needed for most other tax administration tasks, and such skills are sometimes in short supply. Second, the possibility of collusion between taxpayers and tax officials is significant during an audit. Moreover, auditor's errors may damage business activity that makes governments reluctant to support comprehensive audit programs. The development of an effective tax audit program typically addresses coverage (percentage of taxpayers to be audited), selection of audit cases, methods (types of audits to be performed, duration of audit, approaches taken by auditors), staffing and training (staff resources needed to implement the audit program and the training provided for them), and monitoring activities (Ebrill et al. 2001). A good audit program employs strategies to optimize both the direct and the deterrent effects of audits. The first can be achieved by auditing a higher percentage of the large taxpayers (Biber 2010). Although the frequency of audit is a contentious issue, the judgment is always a delicate balance between the treat of audit to check the temptation to evade and the cost. Where the tax system is fairly well established, audits of 15 percent to 20 percent of registered traders a year are sufficient. However, it is not only the crude number of audits that is the most useful measure of need (Tait 1988). In the case of VAT, Ebrill et al. (2001) stated that effective VAT audit program

should cover a 25 to 30 percent of the taxpayers each year. In addition, VAT audit need to be closely coordinated with other tax liabilities especially income tax. Since most countries have integrated VAT and income tax administrations, the development of an effective VAT audit program significantly improves income tax compliance.

### **Independent Variables:-**

#### **2.4.2 Experience and capability of audit staff**

Audit experience is an auditor' unique knowledge, competencies and capabilities that occur from job practices in auditing profession. It enhances the auditor's abilities to process information, make mental comparisons of alternative solutions, and initiate subsequent actions (PaithunIntakhan, 2010).

It explicitly has an effect on decision making efficiency and effectiveness through a good memory of information necessary and an accurate judgment of audit tasks. It helps them identify clients' operational errors and search for their misstated accounts. Likewise, auditors with great experience are likely to improve their judgments with more complete and complex classifications of risk assessments. Audit experience definitely promotes them to build and develop the consistency and consensus of risk judgments, assessments, and evaluations in auditing practices under other conditions, situations, and circumstances. (Ayalew, 2014)

Thus, auditors with more experience tend to perform best audit practices, achieve superior audit outcomes, and gain outstanding audit success. They respond clients' needs, expectations, and requirements by being aware with auditing standards and practice their audit jobs. Audit experience supports the auditors to serve clients having financial difficulties and be made aware of such client situations and problems. Similarly, experienced auditors seem to have no agreements with clients' preferred accounting treatments and be concerned with retaining and pleasing auditing standards, procedures, and processes. They explicitly propose audit judgments and qualified opinions by increasing awareness of the potential adverse consequences of their audit practices. It definitely plays a significant role in attending negative audit evidences and assessing negative control risks. (Ayalew, 2014)

Experienced auditors tend to have more competencies for analyzing clients' evidences and transactions, and interpreting them and presenting audit comments and reports efficiently and effectively. It promotes auditors to have more audit knowledge and more meaningful organizations of knowledge which they have implemented their knowledge relating to misstatements by submitting aggressive audit reports from the audit practices and activities. Audit experience has a significant positive relationship with audit effectiveness (Saidin, 2014).

### **2.4.3 Taxpayers system of record keeping**

All persons who are engaged in a business or trade or who own buildings held all or in part for rental, except for Category “C” taxpayers shall keep books and records. According to the 286/2002 tax proclamation all businesses classified under category ‘A’ & ‘B’ should maintain their own accounting records. However, this is what the law requires but not the practice. In practice most tax payers of taxpayers that are eligible to maintain accounting records don’t have proper accounting records. The main reason for this is that tax payers don’t have the proper awareness about the advantage of maintaining book of accounts and the law which enforces that tax payer to maintain proper accounting records is not properly implemented by the responsible authority. Taxpayers □ system of record keeping is positively related with tax audit effectiveness (Gebeyehu 2008).

### **2.4.4 Taxpayers office information system**

Information system improves the effectiveness of tax audit and collection. Information system is positively influence tax audit effectiveness and collection (Al-Frijat 2013). ICT modernizes tax administration procedures and improve revenue collection (Chatama 2013).

### **2.4.5 Audit case selection and examination method**

The primary goal of revenue authorities is to manage and improve overall compliance with the tax laws, and in the process sustain confidence in the tax system and its administration. Tax audit is a sole treatment for compliance risk available to administrations that allows exercising effective sanctions (imprisonment and penalties and/or interest). It acts as a public sanction making the extent of the administration’s enforcement powers visible within the community and encouraging others to comply. Compliance risk is the failure to comply with the tax law by

taxpayers whether due to their ignorance, carelessness, recklessness, deliberate evasion, or weaknesses in tax administration itself, and have been addressed only by enforcement through an audit-based approach (OECD 2004a).

Accordingly, the first key to successful audit is the case selection methodology. It is critical to select audit candidates consistent with program objectives. Whatever the audit objectives have, the ability to narrow the pasture of potential audit candidates is necessary to achieve program objectives and optimal use of audit resources. Regardless of how automated and efficient the audit process, audit effectiveness would not be realized under the selection of inappropriate audit candidates (Milack undated).

A tax auditor applies various techniques to examine the books and records behind a return. The techniques to be used depend on the taxpayer and the tax regime concerned. The techniques used for audit examination purposes include analytical review, investigative approach, field examination, record examination, and counterpart examination (OECD 2006a).

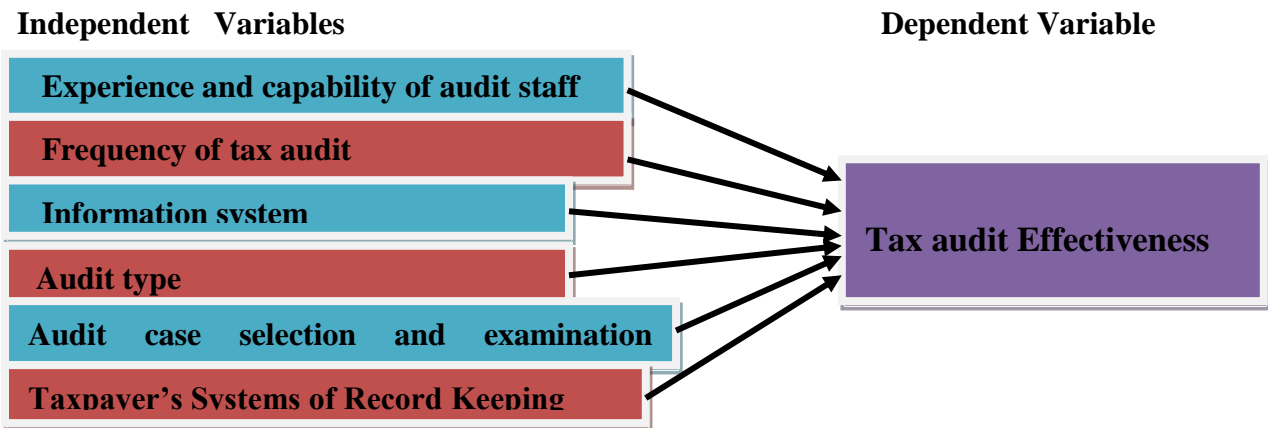
#### **2.4.6 The type of audit used**

Tax audits can vary in their scope and the level of intensity to which they are performed. The nature of audits conducted should reflect the risks to be addressed and desired audit coverage of the taxpayer population. Too many narrowly focused spot (issue) audit provides a high level of audit coverage but at the expense of audit quality, tax revenue, and missed opportunities to properly detect taxpayers' noncompliance. On the other hand, audit activities with an excessive number of in-depth examinations reduce the numbers of audits that might be conducted, possibly leading also to less overall deterrent effect (OECD 2006a).

Therefore, it is inappropriate to carry out all audits on the basis of comprehensive examination of documentation across all tax obligations and all periods that could be open for amendment. Such approach waste resources targeting compliant taxpayers and limit the number of audits that can be undertaken. Therefore, revenue bodies should aim to achieve a balanced program of audits that considers audit coverage, audit quality, and overall deterrent considerations (Biber 2010).

### 2.4.7. Frequency of tax audit

Frequency of tax audit is the time frame audit work will be performed by tax auditor. The frequency of tax audit is positively related with tax audit effectiveness (Getaneh 2011).



## **CHAPTER THREE**

### **RESEARCH DESIGN AND METHODOLOGY**

The previous chapter reviewed both theoretical and empirical studies, and it tried to give a brief conclusion and excavate the gap in the existing knowledge. This chapter presents research design and its methodology to be used in this study. It includes the research design, sampling technique, data collection method, data analysis method and other aspects of the research.

#### **3.1. Research Method**

Explanatory research design was used in line with the objective of the study. Because, the researcher wanted to focus on a very narrow set of data with deep explanations on the study area. Research methods are the techniques used to collect data. In this study, the researcher adopted mixed methods approach, mixed approach includes the use of theory deductively in theory testing and verification, or inductively in an emerging theory or pattern (Mertens, 2003 cited in Creswell, 2007). For this study, the researcher applied quantitative (questionnaire) and qualitative (interview), and as discussed in the following sections. The researcher distributes the questionnaires to the 90 tax auditors and team leaders of LTO and the data was processed on SPSS to make multiple regression and descriptive statistics.

#### **3.2. Target population and sample**

##### **3.2.1. Target Population**

The population of the study includes the entire set tax auditors in large tax payer's office. Accordingly, the target groups for the study were 80 tax auditors of large tax payer's office. In large tax payer's office there are 2 audit process owners which is led by 10 team leaders who coordinate 80 audit experts which is available on the two processes of Large tax payer's office as September 2017.

### **3.2.2. Sampling techniques**

To achieve the objective of the study the researcher used Census method to select the survey respondents. Because, Census method is most reliable especially if the size of population is small (Kothari 2004).

## **3.3. Source of Data**

### **3.3.1 Primary Data Source**

The primary data which was collected through field work survey in order to get information on the issue of tax audit practice and its effectiveness through questionnaire and interview. The structured questionnaire consists of closed ended questions to collect quantitative data from the respondents.

Along with some of the closed ended questions are five score likert scales to provide respondents a wider range of alternative with end points where “5” the level of agreements are represent by 1 to 5. *Strongly agree 1, agree 2, neutral 3, disagree 4, and strongly disagree5.*

### **Questionnaire**

Questionnaires were used to collect primary data form respondents and its advantage is covering a small number of respondents easily and quickly (Kothari 2004). Questionnaires were distributed to the selected respondents to get primary data on the tax audit practice and its effectiveness in enhancing tax revenue. The questionnaires have provided to the tax auditors and have a total of 39 questions; with two parts, its first part have 5 related to respondents profile and in its second part it have 34 questions which were designed to measure variables of the study .tax audit effectiveness with 9 questions, types of audit used and audit case selection and examination method with 5 questions, experience and capability of audit staff and frequency of tax audit with 4 questions and taxpayer’s record keeping and taxpayers office information system with 3 questions.

### **Interview**

An interview is a purposeful discussion and/or conversation with two or more people, and helps the researcher to gather valid and reliable data that are relevant to achieve research questions and objectives. This study applied in-depth interview with process owner and team leader to explore the data that is unclear for the researcher on its questionnaires that explains its variables and the information that have not been collected through questionnaire by allowing the interview to remain flexible (Kothari 2004).

### 3.4. Data Analysis Techniques

The study were specified the variables and models used under the study. Accordingly, the study identified a total of 7(seven) variables including one dependent and six independent variables based on the previous studies (Getaneh 2011, Melat 2016).

To achieve the objective of the study the collected data have been edited, coded and entered in to SPSS version 20 software and processed and analyzed. In the research, raw data is changed into a data structure that enables to generate meaningful and useful bits of information. The major part of the analysis is done based on the descriptive statistics and multiple regressions analysis for quantitative data to examine the study to indicate the tax audit practice and its effectiveness in large tax payers □ branch office.

### 3.5 Model Specification

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \dots + \beta_k X_k + \epsilon \text{ (source: Brooks 2008)}$$

Where:

Y= Dependent variable

$\beta_1 X_1, \beta_2 X_2, \beta_3 X_3 \dots \beta_k X_k$  = Independent variable

$\beta_0$  = constant

$\epsilon$  = Error

$$Y = \beta_0 + \beta_1 ECA + \beta_2 RK + \beta_3 IS + \beta_4 AT + \beta_5 ASE + \beta_6 FA + \epsilon$$

Where:

Y= Tax audit practice Effectiveness

ECA= Experience and capability of audit staff

RK= Tax payers Record keeping

IS= Information system

AT= Audit type

ASE= Audit case selection method and audit examination

FA= Frequency of Audit

## CHAPTER FOUR

### DATA ANALYSIS AND PRESENTATION

#### 4.1 Discussion of Questionnaire Result

The purpose of this project was to produce academic project entitled tax audit practice and its effectiveness in enhancing tax revenue, the case of large tax payer’s branch office. Thus, questionnaire was distributed to respondents of the distributed questionnaire 80 of them properly filled and returned. From the collected questionnaire result was presented as follows:

##### 4.1.1. Socio-demographic Characteristics

Socio demographic characteristics of respondents include education, field of study, current position. The data obtained through data collection instruments summarized as follows:

**Table 1: Socio demographic Characteristics of Respondents**

Demographic characteristics	Response	Frequency	Percent
Level of education	Degree	73	91.3
	Master’s degree &above	7	8.8
Field of study	Accounting	64	80.0
	Management	14	17.5
	Economics	2	2.5
	Total	80	100
Current position in the office	Auditor	76	95
	Team leader	4	5
	Total	80	100
Experience in auditing before LTO	Yes	36	45.0
	No	44	55.0
	Total	80	100

Work experience in auditor	Less than 2 years	27	33.8
	2-4 years	28	35.0
	4-6 years	18	22.5
	6-10 years	5	6.3
	Above 10 years	2	2.5
	Total	80	100

**Source:** SPSS Output from Survey Data, 2018

Table 1 deals with the socio demographic characteristics of respondents. Regarding level of education, 73(91.3) of the respondents categorized in the educational level of degree while 7(8.8%) of the respondents were in the educational level of Masters Degree and above. The second socio demographic characteristics of respondents are field of study. In the context of field to study, 64(80.0%) of the respondents were have field of study accounting while 14(17.5%) are in the field of study of management. Regarding to this, the current position in the office 76(95%) of the respondents were auditor while 4(5%) of the respondents were team leader. From the above information it is possible to conclude that the majority of respondents were in the educational level of degree, field of study was accounting and their current position in the office is auditor. Experience in auditing before LTO, to this issue 44(55%) of the respondents have experience of in auditing before LTO while 36(45%) of the respondent have experience of auditing before LTO. Auditor regarding work experience in auditor 28(35%) of the respondents have work experience in auditor 2-4 years while 27(33.8%) of the respondents were having work experience of less than 2 years. Thus it is clear from the above table that the majority of respondents had relevant work experience between 2-4 years.

#### 4.1.2. Effectiveness of tax audit program

**Table 2: Purpose of tax audit in the large tax payers' office**

Purpose of tax audit performed in large tax payers' office	Frequency	Percent	Mean	SD
To check the evasion of tax	7	8.8	2.6125	1.15280
To ensure compliance in accordance	44	55.0		

with tax law		
Assessment and collection of additional tax revenue	11	13.8
To educate tax payers	9	11.3
Other	9	11.3
Total	80	100

**Source:** SPSS Output from Survey Data, 2018

Table 2 deals with the purpose of tax audit performed in the large tax payers' office. Regarding to this 44(55%) of the respondents reported that the purpose of tax audit performed in the large tax payers offices was to ensure compliance in accordance with tax law while 11 (13.8%) of the respondents reported the assessment and collection of additional tax revenue. Moreover, 9(11.3%) of the respondents reported that the purpose of tax audit performed in the large tax payers office was to educate tax payers. The calculated mean was 2.6125 which is near to coded 2 "to ensure compliance in accordance with tax law" and the standard deviation was concentrated far from the mean. From the above information it is possible to conclude that the purpose of tax audit performed in the large tax payers offices to ensure compliance in accordance with tax law.

**Table 3: Tax audit effectiveness**

Item	Response	Frequency	%	$\chi^2$	df.	P-value
LTO can gather information regarding the tax payers compliance behavior and areas of weakness in the tax law through tax audit program performed	SA	13	16.3	80.00	4	.000
	A	47	58.8			
	N	9	11.3			
	D	11	13.8			
	Total	80	100			
VAT audit is closely coordinated and performed with other tax types, income tax in particular in the LTO	SA	22	27.5	113.2	5	.000
	A	46	57.5			
	N	8	10.0			
	D	4	5.0			
	Total	80	100			

Tax registries traders can easily understand and be aware of the rules, forms and instructions or information provided by the LTO	SA	1	1.3	69.125	4	.000
	A	42	52.5			
	N	16	20.0			
	D	19	23.8			
	SD	2	2.5			
	Total	80	100			
Tax payers believe that there is a good chance to being seized in their under reporting and other non-compliance activities during an audit	SA	3	3.8	40.375	4	.000
	A	28	35.0			
	N	27	33.8			
	D	20	25.0			
	SD	2	2.5			
	Total	80	100			
Tax audit reviews the accuracy and reliability of financial reports	SA	12	15.0	25.100	3	.000
	A	31	38.8			
	N	31	38.8			
	D	6	7.5			
	SD	-	-			
	Total	80	100			
Tax audit reviews the compliance with policies, plans, procedures, proclamations and regulations	SA	26	32.5	41.200	3	.000
	A	40	50.0			
	N	12	15.0			
	D	2	2.5			
	Total	80	100			

**Source:** SPSS Output from Survey Data, 2018

Table 3 showed that tax audit effectiveness to describe tax audit effectiveness statements were designed and the result presented as follows: item 1 is LTO can gather information regarding the tax payers' compliance behavior and areas of weakness in the tax law, through tax audit program. With regard to this, 60 (75.1%) of the respondents reported that agreement to the item while 20(24.1%) of the respondents reported disagreement to the statement. Moreover, to test the result the researcher employed chi-square test. Thus, the chi square value was 80.000 at 4 degrees of freedom. Additionally, the calculated P-value was .000 which is less than 0.05 ( $P < 0.05$ ). This implies that LTO can gather information regarding the tax payers' compliance

behavior and area of weakness in the tax law through tax audit program performed. The second item was VAT audit is closely coordinated and performed with other tax types in the LTO. Concerning to this, 68 (85.0%) of the respondents agreed to the statement while 12(15%) of the respondents were disagreed to the issue. The calculated chi-square was 113.2 at 5 degrees of freedom.

Additionally, the calculated p-value was .000 which was less than the usual statistical rejection threshold, value of 0.05 ( $P < 0.05$ ). This implies that VAT audit is closely coordinated and performed with other tax types income tax in particular in the LTO. The third item was tax registries traders can easily understand and be aware of the rules forms and instructions or information provided by the LTO. Regarding to this, 43 (53.8%) of the respondents reported that agreement to the statement while 21(26.3%) of the respondents reported that disagreement to the item. The calculated chi-square was 69.125 at 4 degrees of freedom. Additionally, the calculated p-value was .000 which was less than the usual statistical rejection threshold value of 0.05 ( $p < 0.05$ ). This implies that tax registered traders can easily understand and be aware of the rules forms and instructions or information provided by the LTO.

Item fourth is tax payers believe that there is a good chance to being seized in their under reporting and other non-compliance activities during an audit. Regarding to this statement 31(38.8%) of the respondents reported that agreement to the item while 22(27.5%) of the respondents reported that disagreement to the item. The calculated mean was 40.375 at 4 degrees of freedom. Additionally, the calculated p-value was .000 which was less than the usual statistical rejection threshold value of 0.05 ( $p < 0.05$ ). This implies that tax payers do not believe that there is a good chance to being seized in their under reporting and other non-compliance activities during an auditor.

Item five is tax audit reviews that accuracy and reliability of financial reports regarding to this, 43(53.8%) of the respondents reported that agreement to the statement while 31(38.8%) of the respondents reported that neutral to the statement.

The final item was tax audit reviews the compliance with policies, plans, procedure, proclamations and regulations regarding to this, 66(82.5%) of the respondents were agreed to the statement while 12(15.0%) of the respondents were neutral to the statement. Moreover, the

calculated chi-square was 41.200 at 3 degrees of freedom. The calculated p-value was .000 which was less the usual statistical significance value of 0.05 ( $p < 0.05$ ). This implies that tax audit reviews the compliance with police, plans, procedures, proclamation and regulations.

### 4.1.3. Tax audit type

**Table 4: Types of tax audits performed by the LTO**

Item	Response	F	%	Mean	SD
Types of audits performed by the LTO	Desk (office audit)	20	25.0	2.8875	1.90930
	Field audit	11	13.8		
	Comprehensive audit	37	46.3		
	Issue audit	3	3.8		
	Advisory audit	3	3.8		
	Refund investigation	3	3.8		
	Other	3	3.8		
	Total	80	100		
Is there responsible unit at the ERCA for the investigation of serious fraud or evasion?	Yes	67	83.8	1.1625	.37124
	No	13	16.3		
	Total	80	100		

**Source:** SPSS Output from Survey Data, 2018

Table 4 deals with types of audits which are usually performed by the LTO. Regarding this 37(46.3%) of the respondents reported that comprehensive audits is the types of audits which are usually performed by the LTO while 20(25%) of the respondents reported that types of audits which are usually performed by the LTO is desk (office audit). The calculated mean was near to 3 which is a code of compressive audit. The standard deviation was concentrated far from the mean. Thus, from the above information it is possible to conclude that type of tax audits performed by the LTO is comprehensive audit. Moreover, the respondents reported that there is a responsible unit at the ERCA for the investigation of serious fraud or evasion. This has been confirmed by 67(83.8%) of the respondents, while 13(16.3%) of the respondents were said that no. the calculated mean was 1.1625 which is near to yes response coded by 1 and the standard

deviation was concentrated far from the mean. This implies that there is responsible unit at the ERCA for the investigation of serious fraud or evasion.

#### 4.1.4. Frequency of Tax audit

Under this section effort was exerted to assess the frequency of tax audit. To describe frequency of tax audit the following statements were designed and the result presented as follows:

**Table 5: Frequency of tax audit**

Item	Response	Frequency	%	X <sup>2</sup>	df	P-value
The LTO has enough tax audit staff resources to perform on site audits on all tax payers or comprehensive cross checking of invoices or transactions.	SA	3	3.8	56.500	4	.000
	A	21	26.3			
	N	17	21.3			
	D	38	47.5			
	SD	1	1.3			
	Total	80	100			
How many audit cases on average individual (one) check auditor has expected to complete in a month at the LTO	<10 cases	58	72.5	101.900	3	.000
	10-20 cases	16	20.0			
	20-30 case	3	3.8			
	Above 30 cases	3	3.8			
	Total	80	100			
How many audit case on average an individual field auditor has expected to complete in a month at the LTO	<4 cases	59	73.8	104.500	3	.000
	4-6 cases	13	16.3			
	7-10 case	6	7.5			
	Above 10 cases	2	2.5			
	Total	80	100			
How many audit cases on average	<100	56	70.0	90.300	3	.000

and individual experienced junior tax auditor has completed during the year 2016/17 at the LTO	cases					
	101-150 cases	10	12.5			
	151-180 cases	13	16.3			
	Above 200 cases	1	1.3			
	Total	80	100			

**Source:** SPSS Output from Survey Data, 2018

Table 5 illustrated that frequency tax audit regarding to this, the following questions and statements were designed and presented as follows. The first item was the LTO has enough tax audit staff resource to perform on site audits on all tax payers or comprehensive cross checking of invoices or transactions to this statement, 24(30.1%) of the respondents were agreed to the statement while 39(48.8%) of the respondents disagreed to the statement. The calculated chi-square value was 56.500 at 4 degrees of freedom. Additionally, the calculated p-value was .000 which was less than the usual statistical rejection threshold value of 0.05 ( $P < 0.05$ ). This implies that the LTO has no enough tax audit staff resources to perform on site audits on all tax payers or compressive cross checking of invoice or transactions. The second item was number of audit cases on average individual (one) check auditor has expected to complete in a month at the LTO 58(72.5%) of respondents were reported that less than 10 cases that on average on auditor can check and complete in a month at the LTO while 16(20.0%) of the respondents reported that 10-20 cases can be checked and complete in a month at LTO by one auditor. The calculated chi-square value was 101.900 at 3 degrees of freedom. Additionally, the calculated p-value was .000 which was less than the usual statistical rejection threshold value of 0.05 ( $p < 0.05$ ). This implies that auditor has expected to complete in a month at the LTO was less than 10 cases. Moreover 59(73.8%) of the respondents reported that less than 4 audit cases on average that an individual field auditor has expected to complete in a month at the LTO while 13(16.3%) of the respondents reported that 4-6 audit cases on average an individual field auditor has expected to complete in a month at the LTO. Additionally, the calculated chi-square value was 104.500 at 3 degrees of freedom. Furthermore, the calculated p-value was .000 which was less than the usual statistical

rejection threshold value of 0.05 ( $p < 0.05$ ). This implies that on average an individual field auditor has expected to complete in a month at the LTO less than 4 audit cases. In addition to this, 56(70.0%) of respondents reported that less than 100 audit cases on average an individual experienced junior tax auditor has completed during the year 2016/17 at LTO. Moreover, 13(16.3%) of the respondents reported that 151-180 audit cases that an average an individual's experienced junior tax auditor has completed during the year 2016/17 at LTO. The calculated chi-square was 90.300 at 3 degree of freedom. Additionally, the calculated p-value was .000 which was less than the usual statistical rejection threshold value of 0.05 ( $p < 0.05$ ). This implies that on average an individual experience junior tax auditor has completed less than 100 audit cases during the year 2016/17 at LTO.

#### 4.1.5. Audit case selection and examination method

To examine the audit case selection and examination method, Statements were designed and the result presented as follows:-

**Table 6: Audit case selection and Examination Methods**

Item	Response	F	%	Mean	SD
Tax auditors have good access to information held by the tax payers and others	SA	3	3.8	3.3125	4.69471
	A	43	53.8		
	N	20	25.0		
	D	14	17.5		
	Total	80	100		
Tax payers cooperate to give essential information for performing an audit	A	43	53.8	2.7000	.83287
	N	18	22.5		
	D	19	23.8		
	Total	80	100		
Tax payers comply with the tax system in Ethiopia	SA	4	5.0	2.8750	1.04790
	A	34	42.5		
	N	13	16.3		
	D	26	32.5		

	SD	3	3.8		
	Total	80	100		
Tax payers (auditee) are selected based on their associated compliance risk	SA	4	5.0		
	A	61	76.3		
	N	11	13.8	2.1875	.59733
	D	4	5.0		
	Total	80	100		
Tax audit is a sole treatment for compliance risk available to LTO	SA	10	12.5	2.5250	.9675
	A	34	42.5		
	N	21	26.3		
	D	14	17.5		
	SD	1	1.3		
	Total	80	100		

**Source:** SPSS Output from Survey Data, 2018

Table 6 deals with audit case selection and examination method. Regarding to this, statements were designed which describe audit case selection and examination method. Item one is tax auditors have good access to information held by the tax payers and others. To this issue 46(57.6%) of the respondents reported that agreement to the issue while 20(25.0%) of the respondents were neutral to the issue. The calculated mean was 3.3125 which were greater than the likert scale mean. The standard deviation was concentrated far from the mean. Thus, from the above information it is possible to conclude that tax auditors have good access to information held by the tax payers and others. The second item is tax payers cooperate to give essential information for performing an audit 43(53.8%) of the respondents were agreed to the statement while 19(23.8%) of the respondents were disagreed to the statement. The calculated mean was 2.7000 which was less than the likert scale mean 3. The standard deviation was concentrated far from the mean. This implies that tax payers cooperate to give essential information for performing an audit. The third item was tax payers comply with the tax system in Ethiopia. To this statement 38(47.5%) of the respondents were disagreed to the statement. The calculated mean was 2.8750 and the standard deviation was concentrated far from the mean. This implies tax payers are disagreed to comply with the tax system in Ethiopian.

Item four is tax payers (auditee) are selected based on their associated complained risk. Regarding to this; 65(81.3%) of the respondents were agreed to the item while 11(13.8%) of the respondents were neutral to the statement. The calculated mean was 2.1875 which was less than the likert scale mean (3). Additionally the standard deviation was concentrated far from the mean. This implies that tax payers' auditee are selected based on their associated compliance risk.

Item five and tax audit is a sole treatment for compliance risk available to LTO. Regarding to this 44(54.0%) of the respondents were agreed to statement while 15(18.8%) of the respondents were disagreed to the statement the calculated mean was 2.5250 and the standard deviation was concentrated for from the mean. This implies that tax audit is a sole treatment for compliance risk available to LTO.

#### 4.1.6. Experience and Capability of Audit Staff

Regarding this issue statement were designed which can describe experience and capability of audit staff.

**Table 7: Experience and Capability of Audit staff**

Item	Response	Frequency	%	X <sup>2</sup>	Df	P-value
The current working capacity of audit staff is well aware of the tax law and regulations	SA	1	1.3	65.375	4	.000
	A	34	42.5			
	N	32	40.0			
	D	12	15.0			
	SD	1	1.3			
	Total	80	100			
Is there any rule in the LTO that requires the audit work to be started and competed with in a pre-determined time frame	Yes	39	48.8	16.625	2	.000
	Neutral	31	38.8			
	No	10	12.5			
	Total	80	100			

Tax audits are finalized according to consistent process and assurance a level of customer satisfaction	SA	5	6.3	21.100	3	.000
	A	29	36.3			
	N	30	37.5			
	D	16	20.0			
	Total	80	100			

**Source:** SPSS Output from Survey Data, 2018

Table 7 illustrated that experience and capability of audit staff. Regarding to this, 35(43.8%) of the respondents reported that agreement to the statement while 13(16.3%) of the respondent reported that disagreement to the statement. Furthermore, the calculated chi-square was 65.375 at 4 degrees of freedom. Additionally the calculated p-value was .000 which was less than the usual statistical rejection threshold value 0.05 ( $p < 0.05$ ). This implies that the current working capability of audit staff is well aware of the tax law and regulations. Item two deals with whether there is any rule in the LTO that requires that audit work to be started and completed within a predetermined time frame or not. To this issue 39(48.8%) of the respondent were said yes while 31(38.8%) of the respondent said neutral. The calculated chi-square was 16.625 at 2 degrees of freedom. Additionally, the calculated p-value was .000 which was less than the usual statistical rejection threshold value of 0.05 ( $p < 0.05$ ). From the above information it is possible to conclude that there is any rule in the LTO that requires the audit work to be started and completed within a predetermined time frame.

Item three is tax audits are finalized according to consistent process and assurance a level of customer satisfaction. Regarding to this, 34(42.6%) of the respondents said agree while 30(37.5%) of them said disagree. The calculated mean was 27.100 at 3 degree of freedom. Additionally, the calculated p-value was .000 which was less than the usual statistical rejection threshold value of 0.05 ( $p < 0.05$ ). This implies that tax audits were performed according to consistent standards and to the level assurance of customers (taxpayers) satisfaction.

#### **4.1.7. Tax payers Recording Keeping**

To describe tax payers recording keeping the following questions were designed and the result presented as follows:

**Table 8: Tax payers recording keeping**

Item	Response	Frequency	%	Mean	SD
Is there any legal framework to see the tax payers' record keeping?	Yes	60	75	1.2500	.4357
	No	20	25		
	Total	80	100		
Are tax payers cooperate to give essential information?	Yes	55	68.8	1.3125	.46644
	No	25	31.3		
	Total	80	100		
Where can you see these record keepings?	In the business premise	66	82.5		
	Can be taken outside the business premise if needed	14	17.5	1.1750	.38236
	Total	80	100		

**Source:** SPSS Output from Survey Data, 2018

Table 8 showed that tax payers record keeping. Regarding to this 60(75%) of the respondents were said that yes there is any legal framework to see the tax payers record keeping while 20(25%) of the respondents said that no there is no any legal framework to see the tax payers record keeping the calculated mean was 1.2500 which is near to 1 which is 1 is coded yes and the standard deviation was concentrated far from the mean. This implies that there is any legal framework to see the tax payer's record keeping. Moreover, 66(82.5%) of the respondents reported that the record keepings can be seen in the business premise while 14(17.5%) of the respondents reported that the record keepings can be taken outside the business premise of needed. The calculated mean was 1.1750 and the standard deviation was concentrated far from the mean. This implies that record keeping can be taken outside the business premise of needed.

#### 4.1.8. Tax payers office Information System

Regarding tax payers office information system the following question were presented and the result summarized as follows.

**Table 9: Tax payers office information system**

Item	Response	Frequency	%	Mean	SD
LTO information system accessible to the tax auditor	SA	3	3.8	2.6125	.80338
	A	38	47.5		
	N	26	32.5		
	D	-	-		
	Total	80	100		
Does LTO provide training regarding information system applied in the LTO	Yes	7	8.8	3.5000	1.04336
	Usually	5	6.3		
	Neutral	16	20.3		
	Sometimes	45	56.6		
	No	7	8.8		
	Total	80	100		
Is information system used in the LTO appropriate for effectiveness of tax audit	Yes	49	61.3	1.3875	.49025
	No	31	38.8		
	Total	80	100		

**Source:** SPSS Output from Survey Data, 2018

Table 9 showed that tax payers office information system. To this regard, 41 (51.3%) of the respondents reported that agreement to the statement while 26(32.5%) of the respondents reported that natural to the statement. The calculated mean was 2.6125 which is near to 2. Coded 2 is agreement. More over the standard deviation was concentrated far from the mean. From the above information it is possible to conclude that LTO information system accessible to the tax auditor.

The second question was does LTO provide training regarding information system applied in the LTO. To this questions 45(56.3%) of the respondent said some times while 16(20.3%) of them were neutral. The calculated mean was 3.5000 and the standard deviation was concentrated far from the mean. From the above information, it is possible to conclude that LTO provide training regarding information system applied in the LTO is sometimes. More over 49(61.3%) of the respondents said that information system used in the LTO appropriate for effectiveness of tax audit while 31(38.8%) of the respondents said no. The calculated mean was 1.3875 and the standard deviation was .49025. Thus, from the above information it is possible to conclude that information system used in the LTO appropriate for effectiveness of tax audit.

## 4.2. Regression Analysis

In this study a linear regression analysis was conducted to test the influence of predictor variable. The researcher used statistical package for social science to code, enter, and compute the measurement of the regression.

**Table 10: Linear regression model**

<b>Model Summary</b>				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.932 <sup>a</sup>	.869	.858	.35163
a. Predictors: (Constant), Tax audit Type, experience and capability of Audit staff , tax payers record keeping , tax payers office information system , audit case selection and examination , Frequency of tax Audit				

Table 10 showed that the coefficient of determination explains the extent to which changes in the dependent variable can be explained by changes in the independent variable or the percentage of variation in the dependent variable (tax audit practice effectiveness) that can be explained by all the independent variables (tax payers office information system, frequency of tax audit, tax payers record keeping , audit case selection and examination, experience and capability of audit staff, and audit type). The correlation and coefficient of determination of the dependent variable when all the independent variables are combined was also measured and tested as shown in the table above. From the findings, 86.9% of the variation in the tax audit practice effectiveness is attributed to a combination of all independent factors (tax payers office information system,

frequency of tax audit, tax payers record keeping, audit case selection and examination, experience and capability of audit staff, audit type) investigated in this study.

**Table 11: ANOVA result**

ANOVA <sup>a</sup>						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	59.724	6	9.954	80.504	.000 <sup>b</sup>
	Residual	9.026	73	.124		
	Total	68.750	79			
a. Dependent Variable: tax audit effectiveness						
b. Predictors: (Constant), Tax audit Type, experience and capability of Audit staff , tax payers record keeping , tax payers office information system , audit case selection and examination , Frequency of tax Audit						

**Source:** SPSS Output from Survey Data, 2018

Table 11 showed that analysis of variance result. The F-Test generated by ANOVA was used to test for overall significance of the model. The findings in above show that the  $F_{6,73}$  statistic of 80.504 was not significant with a P-value  $> 0.05$ . The model therefore did not establish a relationship between the tax audit practice effectiveness and tax payers office information system, frequency of tax audit, tax payers record keeping , audit case selection and examination, experience and capability of audit staff, audit type .

**Table 12: Regression Coefficient result**

Coefficients <sup>a</sup>						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.314	.257		-1.220	.226
	Frequency of tax Audit	.092	.133	.109	.693	.491
	Audit case selection and examination	.371	.133	.357	2.802	.006
	Experience and capability of Audit staff	.374	.138	.310	2.719	.008
	Tax payers record keeping	-.049	.244	-.024	-.202	.841
	Tax payers office information system	-.016	.106	-.017	-.153	.878
	Tax audit Type	.504	.216	.254	2.332	.022
a. Dependent Variable: Tax Audit Effectiveness						

**Source:** SPSS Output from Survey Data, 2018

$$\text{Tax audit practice effectiveness (Y)} = -.314 + .504\text{AT} + .374\text{ECA} + .371\text{ASE} + -.049\text{RK} + -.016\text{IS} + .092\text{FA}$$

This regression equation above has established that taking all factors in to account tax payers office information system, frequency of tax audit, tax payers record keeping , audit case selection and examination, experience and capability of audit staff, audit type constant at zero the effect of the factor will be -.314 . The finding also show that taking at other independent variables at zero, the unit increase in audit type would lead to a .504 At t = 2.332, p= .022 increase in tax audit practice effectiveness. Furthermore, the finding shows that a unit increase in experience and capability of audit staff would lead to a .374 at t= 2.719 p= .008 increase in tax audit practice effectiveness. In addition the finding show that a unit increase audit case selection and examination would lead to a .371 at t =2.802, p= .006 increase tax audit practice effectiveness. A unit increase of tax payers record keeping would lead to -.049 at t= -.203, p= .841 increase as tax audit practice effectiveness. A unit increase in tax payers information system would lead to -.016 at t=-.153, p = .878 increase as tax audit practice effectiveness. A unit increase in frequency of tax of tax audit would lead to .092 at t=0.693, p=.491. The t-tests were used to test the significance of individual variables. The t-test indicates that the tax audit practice effectiveness do depend on audit case selection and examination, experience and capability of audit staff, audit type is significant at p <0.05. From the above information, the first tax audit type, the second is experience and capability of audit staff and the third audit case selection and examination technique.

**Table 13: Correlation Analysis**

Correlations								
		tax audit effectiveness	Tax audit Type	Frequency of tax Audit	audit case selection and examination	experience and capability of Audit staff	tax payers record keeping	tax payers office information system
tax audit effectiveness	Pearson Correlation	1						
	Sig. (1-tailed)							
	N	80						
Tax audit Type	Pearson Correlation	.842**	1					
	Sig. (1-tailed)	.000						
	N	80	80					
Frequency of tax Audit	Pearson Correlation	.891**	.874**	1				
	Sig. (1-tailed)	.000	.000					
	N	80	80	80				
Audit case selection and examination	Pearson Correlation	.904**	.840**	.920**	1			
	Sig. (1-tailed)	.000	.000	.000				
	N	80	80	80	80			
Experience and capability of Audit staff	Pearson Correlation	.867**	.734**	.865**	.865**	1		
	Sig. (1-tailed)	.000	.000	.000	.000			
	N	80	80	80	80	80		

Tax payers record keeping	Pearson Correlation	.808**	.888**	.901**	.828**	.724**	1	
	Sig. (1-tailed)	.000	.000	.000	.000	.000		
	N	80	80	80	80	80	80	
Tax payers office information system	Pearson Correlation	.844**	.783**	.826**	.875**	.892**	.704**	1
	Sig. (1-tailed)	.000	.000	.000	.000	.000	.000	
	N	80	80	80	80	80	80	80
**. Correlation is significant at the 0.01 level (1-tailed).								

**Source:**-SPSS output survey data 2018

Table 13 showed that correlation of dependent and independent variables. The correlation value range between -1 and 1, if the correlation result is near to -1 it implies that the result is negative strong relationship while the result is near to 1 it implies that the correlation is strong positive relationship. Based on this, tax audit type is correlated with tax audit effectiveness at .842 which is positively correlated and the calculated p-value was .000 which was less than 0.01. Frequency of tax audit is correlated with tax audit effectiveness at .891. Additionally the calculated p-value was .000 which was less than 0.05 (p less than 0.01). This implies that frequency of tax audit is positively correlated. Audit case selection and examination method is correlated with tax audit effectiveness at .904. Moreover the calculated p-value was .000 which was less than the statistical significant value 0.01. Experience and capability of audit staff correlated with tax audit effectiveness at .867. The p-value was .000 which was less than 0.01. The result is statistically significant. Tax payers record keeping correlated with tax audit effectiveness at .808. The p-value was .000 which was less than 0.01. Tax payers office information system was correlated with tax audit effectiveness at .844. The p-value was .000 which was less than 0.01.

### **4.3. Discussion of Interview**

The interview result shows that LTO auditors performs exhaustively comprehensive audit. However, along with the start of the implementation of the risk-based taxpayer selection system in July 2009, audit methodologies especially desk audit, and others such as field audit and spot (issue) audit come to existence in branch offices. The interview results also revealed that LTO tax auditors critically conducts investigation audit only at headquarter level based on the information that comes from various sources with evidence regarding the deliberate evasion or serious fraud.

The in-depth interview with process owners also showed that tax needs to be based on voluntary registration, and should encourage taxpayers to voluntarily discharge their tax obligations in Ethiopia. As a result, the purpose of tax audit is primarily to educate taxpayers and improve their voluntary compliance. The interview respondents further stated that the duty of taxpayers' awareness creation is unquestionable to increase voluntary compliance and to mitigate compliance risks. Consequently, ERCA tried to create tax awareness through electronic media, printed materials, websites (uploading information and accessed to the public), and some face-to-face discussion forum with taxpayers in collaboration with Addis Ababa Chamber of Commerce. On the other hand, the process owners highlight on the interview the purpose of audit is to teach the taxpayer to comply for the tax laws and to truly & timely pay its obligation.

Furthermore, interview with process owners showed that LTO used tax audit as a compliance enforcement tool to collect unpaid taxes from taxpayers and to ensure the deterrent effect (improving future compliance). The interview respondents further stated that ERCA has sufficient powers to enter business premise, seize documents, gather information from third parties such as banks, and generally enforce payment of tax. The noncompliant taxpayers that have been considered as a big fish are penalized and enforced to pay the evaded tax with penalty and interest so as to maximize their future compliance as well as to educate others to comply by publicizing such enforcement.

Currently regarding audit staff recruitment and development, the in-depth interview with process owners that tax auditors and investigators are employed in ERCA based on their level of education and cumulative grade point average (CGPA). Currently, ERCA hired a mass of youngest employees from newly graduated students, accounting and finance graduates as a tax auditor in particular. The interview respondents also stated that previous audit related work experience is preferable, and every recruited auditors and investigators should have good ethical behavior. In addition, at the time of recruitment, all candidate employees are expected to attend training regarding government policies and strategies, overall objectives and structure of ERCA, tax rules and regulations, and one week basic audit training (for candidate tax auditors). After the completion of the training, all the trainees are expected to take the exam (in-house tests) based on the training they attended for assessment purpose. Nevertheless, the interview with tax officials revealed that there is no a well-established model to make a continuous competency assessment.

The in-depth interview with process owners further showed that tax auditors are categorized in to audit teams having their own team coordinators. Under each audit team, there are three levels of auditors: junior auditor, auditor, and senior auditor. The tax audit team coordinators assign audit cases to their own team members based on the auditors experience and capability as well as the complexity of cases. The simple and medium cases are expected to be performed by junior auditors and auditors, whereas very complex cases are assigned to senior auditors.

## CHAPTER FIVE

### CONCLUSIONS AND RECOMMENDATIONS

#### 5.1 Conclusions

The aim of this study is to investigate tax audit practice and its effectiveness in enhancing tax revenue the case of large tax payer's branch office. The assess tax audit practice and its effectiveness, the researcher developed dimensions of tax audit which include types of tax audit used, frequency of tax audit, audit case selection and examination method, experience and capability if audit staff, tax payers record keeping and, taxpayers office information system on tax audit practice. The study adopted both quantitative and qualitative approach. Ninety questionnaires were distributed to the respondents. Of the distributed questionnaires eighty of them were properly filled and returned and used for analysis. Regression model is employed by considering tax audit practice and its effectiveness as dependent variables, this was basically done to get the best linear combinations of the constructs as well as to get predictive value of individual predictors for testing the hypotheses proposed. The results of the study enable us to conclude that tax audit type, experience and capability of audit staff and audit case selection and examination method as a linear combination significantly influence tax audit effectiveness in the organization studied. However, tax payers' record keeping, tax payers' office information, frequency of tax audit experience and capability of audit staff and audit case selection and examination method are not significantly to undermine tax audit effectiveness.

Tax audit program remains undeveloped with an emphasis on comprehensive and desk audit with the exclusion of other audit methodologies. There is a slight range of tax audit activities performed targeting aptly specific risks, which might result in less proportionate and measured responses in terms of additional revenue collection and voluntary compliance improvement.

Further, the audit program performed in LTO could detect noncompliance behavior of individual taxpayers, and used as a compliance enforcement tool to collect unpaid or evaded tax return and to ensure the deterrent effect. Through audit, LTO utilizes its enforcement powers in addressing

tax revenue in arrears and evasion challenges, and makes its power visible to the community to encourage noncompliant taxpayers to comply. However, tax audit practice in LTO is a toddler tool in improving voluntary compliance through helping taxpayers to understand their tax and customs obligations that could generate the right tax revenue at the right time.

To check the accuracy of tax returns, various types of information might be reviewed namely tax returns, financial statements, accounting records, customs declaration and other source documents. The accuracy of taxpayers' tax liability is determined mainly through analytical review of financial statements and returns. However, the application of investigation approach is not as such in practice, and it might be difficult to determine what wealth the taxpayers have accumulated but not documented or recorded in their books of accounts and financial reports.

Regarding audit staff, there is no competency assessment model, and less emphasis is given for continuous upgrading the capability and knowledge of staff resources once they have given and held a particular position. There is also higher staff turnover in the tax authority, tax audit team in particular. The authority fails to retain proficient and well-trained auditors. As a result, LTO does not have experienced and proficient tax auditors. Tax auditors are not at the required level of operational capability to conduct tax audit and professional capability to give appropriate services to taxpayers. The incapability of tax auditor might be due to absence of using effective pre-audit plan and inadequate audit training as well as their lack of willingness.

## **5.2. Recommendations**

On the base of the findings/conclusion derived; the following recommendation was made by the researcher. In order to improve the tax audit effectiveness, large taxpayer's office should consider the following points:

- As it was explained tax audit type play significant role on tax audit effectiveness. Thus, large tax payers branch office should emphasis on the predictor, except frequency of tax audit, tax payers record keeping and tax payers office information system

- To increase the audit coverage and voluntary compliance having inadequate staff resources, the LTO should adopt a wide range of audit methodologies rather than use of full comprehensive audit. The spot (issue) audit should be widely applied to increase the audit coverage, and education type audits that are not yet in place should be implemented to improve taxpayers' awareness and voluntary compliance. In addition, LTO should give emphasis and assign adequate audit staff to investigate audit, and it is better to conduct such audit type.
- LTO should give emphasis for all levels of taxpayer segments to improve future overall taxpayers voluntary compliance that may affect future tax revenue, and to be capable to sustain confidence in the tax system and its administrations. All levels of taxpayer community should feel that their underreporting and other noncompliance activities have a good chance of being detected due to high probability of being audited.
- There should be appropriate need assessment and employees should be given training based on the gap identified. Auditors should have been given continuous training so that their skills are kept up-to-date and relevant. Further, the authority should supply sufficient computers and other necessary audit resources for auditors. The authority should also found a mechanism to retain the qualified tax auditors. Besides, the reason why staff resources of LTO, tax audit team in particular resign themselves from their position after some years of experience might need a detail investigation and can be a researchable topic in the future.

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## Appendix 1 Questionnaire



**Wolkite University**

*We Strive for Wisdom!*

COLLEGE OF BUSINESS AND ECONOMICS

SCHOOL OF POST GRADUATE

DEPARTMENT OF ACCOUNTING AND FINANCE

### **Dear participant**

This project is entitled “**Tax audit practice and its effectiveness in enhancing tax revenue: The case of large taxpayer’s branch office**”. The investigator is Melaku kinfe who is currently an MSc (in Accounting and Finance) student at the wolkite University.

I am going to ask you some questions about profile of large tax payer’s office audit department. Participation in this project is completely voluntary. You have the right to refuse, to take part or to contact at any time. But the information that you will give us is quietly useful to know about large tax payer’s office audit effectiveness. Survey results will be recorded anonymously, and strict confidentiality will be maintained.

I would like to assure you your name will not be mentioned in anywhere. The information that you will give us will be kept confidential and only be used for the research purpose.

THANK YOU

Part I: Background information

1. What is your level of education?

Certificate -  1

Diploma -  2

Degree -  3

Master's degree or above -  4

2. What is your field of study?

Accounting -  1

Management -  2

Economics -  3

3. What is your current position in the office?

Process owner -  1

Auditor -  2

Team leader -  3

4. Did you have any audit experience before you joined LTO?

Yes  No

5. If your answer in question no. 4 is yes how long have you been working as an auditor?

Less than two years -  1

2-4 years -  2

4-6 years -  3

6-10 years  4

Above 10 years -  5

**Part II: Questions regarding the effective tax audit program:**

6. What is the primary purpose of tax audit performed in the large taxpayers  office?

To check the evasion of tax  1

To ensure compliance in accordance with tax law  2

For assessment and collection of additional tax revenue  3

To educate taxpayers  4

Others 5, please specify \_\_\_\_\_

7. What are the main activities that tax auditors perform during an audit period?

Detecting noncompliance behavior of individual taxpayer 1

Gather information on the health of the tax system including compliance behavior 2

Educating taxpayers 3

Interpreting complex tax rules and regulations for taxpayers 4

Identify areas of tax law that require clarification and amendment  5

Others  6, please specify \_\_\_\_\_

8. LTO can gather information regarding the taxpayers  compliance behavior and areas of weaknesses in the tax law through tax audit program performed.

Strongly agree  1 Agree  2 Neutral  3 Disagree  4 Strongly disagree  5

9. VAT audit is closely coordinated and performed with other tax types, income tax in particular, in the LTO

Strongly agree  1 Agree  2 Neutral  3 Disagree  4 Strongly disagree  5

10. Tax registered traders can easily understand and be aware of the rules, forms, and instructions or information provided by the LTO.

Strongly agree  1 Agree  2 Neutral  3 Disagree  4 Strongly disagree  5

11. Taxpayers believe that there is a good chance of being seized in their underreporting and other noncompliant activities during an audit.

Strongly agree  1 Agree  2 Neutral  3 Disagree  4 Strongly disagree  5

12. Tax audit program performed by the LTO makes its power visible to the community and encourages noncompliant taxpayers to comply.

Strongly agree  1 Agree  2 Neutral  3 Disagree  4 Strongly disagree  5

13. Tax audit reviews the accuracy and reliability of financial reports.

Strongly agree  1    Agree  2    Neutral  3    Disagree  4    Strongly disagree  5

14. Tax audit reviews the compliance with policies, plans, procedures, proclamations and regulations.

Strongly agree  1    Agree  2    Neutral  3    Disagree  4    Strongly disagree  5

15. What types of audits are usually performed by the LTO?

Desk (office) audit  1    Field audit  2    Comprehensive audit  3    Issue audit  4

Advisory audit  5    Registration check  6    Refund audit  7    Fraud investigation  8

Others 9, please specify \_\_\_\_\_

16. When and in what condition the audit type that you have selected in Q #15 above would be conducted?

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17. Is there a responsible unit at the ERCA for the investigation of serious fraud or evasion?

Yes  1                      No  2

18. How those responsible units in question #17 decide about the need to investigate a certain taxpayer?

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19. If your answer is yes to question #17, when and how an investigation on a selected taxpayers is conducted? \_\_\_\_\_

20. The LTO has enough audit staff resources to perform onsite audits on all taxpayers or comprehensive crosschecking of invoices or transactions.

Strongly agree  1    Agree  2    Neutral  3    Disagree  4    Strongly disagree  5

21. How many audit cases on average an individual (one) desk auditor has expected to complete in a month at the LTO?

Less than 10 cases  1

10 to 20 cases  2

20 to 30 cases  3

Above 30 cases  4

22. How many audit cases on average an individual field auditor has expected to complete in a month at the LTO?

Less than 4 cases  1

4 to 6 cases  2

7 to 10 cases  3

Above 10 cases  4

23. How many audit cases on average an individual experienced junior tax auditor has completed during the year 2016/17 at the LTO?

Less than 100 cases  1

101 to 150 cases  2

151 to 180 cases  3

181 to 220 cases  4

Above 200 cases  5

24. Tax auditors have good access to information held by the taxpayers and others.

Strongly agree  1    Agree  2    Neutral  3    Disagree  4    Strongly disagree  5

25. Taxpayers cooperate to give essential information necessary for performing an audit.

Strongly agree  1    Agree  2    Neutral  3    Disagree  4    Strongly disagree  5

26. Taxpayers comply with the tax system in Ethiopia.

Strongly agree  1    Agree  2    Neutral  3    Disagree  4    Strongly disagree  5

27. Taxpayers (auditee) are selected based on their associated compliance risk.

Strongly agree  1    Agree  2    Neutral  3    Disagree  4    Strongly disagree  5

28. Tax audit is a sole treatment for compliance risk available to LTO.

Strongly agree  1    Agree  2    Neutral  3    Disagree  4    Strongly disagree  5

29. The current working capacity of audit staff is well aware of the tax laws and regulations.

Strongly agree  1    Agree  2    Neutral  3    Disagree  4    Strongly disagree  5

30. Is there any rule in the LTO that requires the audit work to be started and completed within a predetermined timeframe?

Yes  1    Neutral  2    No  3

31. If your answer is yes to question #30, are taxpayers aware for this rule? How substantial audit frauds that found out of the audit period could be treated?

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32. Tax audits are finalized according to consistent process and assurance a level of customer satisfaction.

Strongly agree  1    Agree  2    Neutral  3    Disagree  4    Strongly disagree  5

33. Is there any legal frame work to see the taxpayers' record keeping.

Yes  1    No  2

34. If yes, where can you see these record- keepings

In the business premise  1

Can be taken outside the business premise if needed  2

35. Are the taxpayers cooperate to give essential information's?

Yes  1    No  2

36. Is LTO information system accessible to the tax auditor?

Strongly agree  1    Agree  2    Neutral  3    Disagree  4    Strongly disagree  5

37. Does LTO provide training regarding information system applied in the LTO?

Yes  1      Usually  2      Neutral  3      Sometimes  4      No  5

38. Is information system used in the LTO appropriate for effectiveness of tax audit?

Yes  1      No  2

39. Do you have any ideas, opinions and suggestions that have not been included in the  
aforementioned questions?

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**Thank you for your cooperation**

## **Appendix 2 process owners and team leaders interview instrument**

1. What is the primary purpose of conducting an audit?

2. How the decision to audit or investigate a certain taxpayer is conducted? What inference or criteria considered for such decision?
3. Could you tell me the level of taxpayer's tax awareness and compliance behavior for Ethiopian tax system? If they are not aware, what LTO plans to do regarding awareness creation and compliance improvement?
4. Do you believe that LTO has currently collecting the potential amount of tax revenue? If yes, how is it achieved? If not, could you tell me the reason behind, and on what audit cases should LTO concentrate in its audit work?
5. How and in what condition desk audit, field audit, comprehensive audit, single audit, advisory audit, registration audit, record keeping audit, refund audit, and fraud investigation is performed in LTO? Which audit type is mostly performed? Why could it be?
6. How audit cases are selected? What are the bases considered for selecting the audit case?
7. How and by what criteria audit cases are assigned to senior and junior auditors?
8. Are there any exam, tutor, and training to hire an auditor or investigator? If so, when and how the trainings and exams are provided?
9. Could you tell me the required capabilities of auditors, investigators and audit managers in LTO?
10. Is there any continuous assessment on competency of tax audit staff? If yes, who performs the assessment? When and how these assessments are conducted? What about the continuous knowledge upgrading processes of staff resources?

11. How long an individual tax audit employee stays on average in LTO? Is there a possibility of tax auditors and investigators resign themselves from their position in LTO? Would you tell me the reason behind this?

12. How the rank of junior and senior auditors is categorized? When and how do the junior auditors promote to the position of senior auditors?